

Considerations for Financial Facilities to Support Water Utilities in the COVID-19 Crisis

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1818 H Street NW, Washington, DC 20433

Telephone: 202-473-1000; Internet: www.worldbank.org

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Abbreviations

AFD	Agence Française de Développement (French Development Agency)
BNDES	Banco Nacional de Desenvolvimento Econômico e Social (Brazilian Development Bank)
CAPEX	capital expenditure
DPF	Development Policy Financing
FIA	Financiamiento de Inversiones en Agua (Colombia)
GDP	gross domestic product
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
KPI	Key Performance Indicator
LWUA	Local Water Utilities Administration (Philippines)
MIGA	Multilateral Investment Guarantee Agency
MFD	Maximizing Finance for Development
ODA	Official Development Assistance
OECS	Organization of Eastern Caribbean States
OPEX	operational expenditure
PPE	personal protective equipment
PPP	Paycheck Protection Program (U.S.)
SIDA	Swedish International Development Cooperation Agency
U.K.	United Kingdom
U.S.	United States



Chapter 1

Introduction, Objective, and Context

The objective of this document is to lay out the options and considerations in the design of facilities to provide emergency financial support to water utilities in response to the COVID-19 pandemic. It builds on the experiences of previous financial crises (such as the global financial crisis of 2007–08 and the Asian Financial Crisis of 1997), including their impact and responses to them. Its main audience is government policy makers trying to develop financial responses to ensure utilities continue to function during the crisis, as well as the World Bank country teams and Task Team Leaders assisting them. The type of facility described in this document may be based on an existing one or related mechanisms (fiscal transfers, guarantees, subsidy programs, or others), or it could be a new institution or financing instrument that may continue to have a role in sector financing after the crisis.

Addressing the issues in this document is urgent in terms of delivering and expanding water services during the COVID-19 crisis. Indicative information from World Bank client countries shows that the financial implications have already reached many water utilities, including dramatically affecting revenues. Some figures indicate decreases of as much as 70 percent in the first few weeks of the pandemic. At the same time, in many instances, costs are increasing because of pandemic-related operational costs, such as personal protective equipment (PPE) and workplace adjustments, as well as government-mandated service reforms, such as the expanded provision of public standpipes, water tankers, and handwashing facilities.

Rather than attempting definitive recommendations, this paper points out options, advantages and disadvantages, and specific factors that can influence the design of financing facilities. Diverse local factors, such as the scale of the pandemic, socioeconomic impact, the state of national and local finances, and institutional frameworks and capacities, will all be paramount in terms of developing concrete recommendations. Nevertheless, to provide clear guidance on the options, Appendix A provides a Decision Tree that key policy makers can use to guide and expedite the decision-making process.

Although the paper addresses funding and financing issues, it does not provide an exhaustive discussion on the array of financing instruments and facilities that could be developed to support water utilities or sector reform agendas in the long term. Rather the focus is on responding to the present emergency in terms of addressing the cash flow impact of the COVID-19 crisis, including the option for a stabilization program, if appropriate. The paper builds on blended finance models to assist creditworthy or near-creditworthy utilities to move away from purely concessional donor finance to more sustainable market financing within the context of the pandemic.

Depending on the scale of the crisis and preexisting financial sustainability and creditworthiness of water utilities, some utilities may have the financial strength to use internal resources or cash reserves to raise finances on their own and weather the storm without government assistance. Those utilities should be encouraged to do so within their legal and regulatory mandates. However, the premise of this

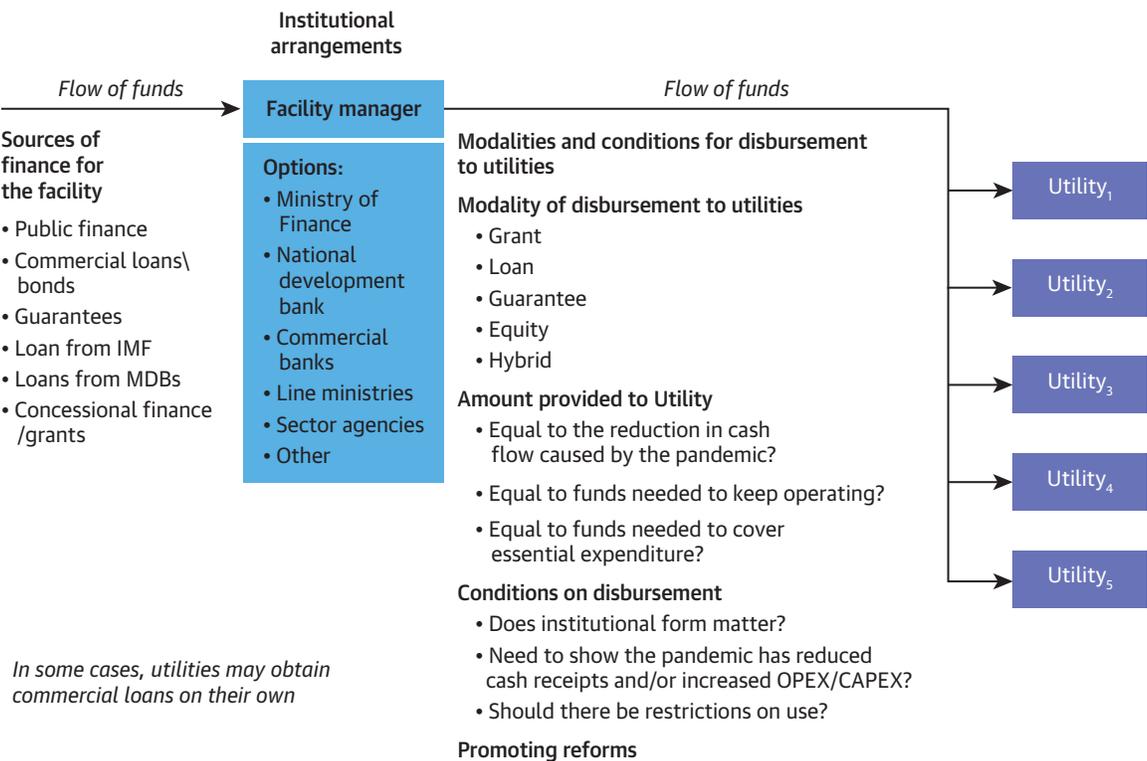
paper is that most utilities in emerging markets will not be able to do this without financial support and that national governments will be the linchpin of that support.

In light of this, the paper recognizes that there will likely be a need to consider new external borrowing in the context of ensuring macroeconomic and fiscal stability. Many emerging markets were already showing signs of over-indebtedness before the COVID-19 crisis and the costs associated with the pandemic will only increase the demand for resources, including public debt. Macro-economic stability must be anchored on sustainable paths of public and external debt, and countries will need to consider this in coordination with ongoing initiatives by the Group of Twenty (G20), the International Monetary Fund (IMF), and others to ensure debt sustainability and transparency.

Summary of Three Main Considerations

Figure 1.1 summarizes the three main considerations in designing a financing facility: institutional arrangements, sources of finance, and modalities and conditions for disbursements, which are detailed in chapter 2. For the purposes of this document, a *facility* is defined as an entity or instrument to channel funds to water utilities to enable them to provide essential services, overcoming the financial impact of the COVID-19 pandemic.¹ Given its target audience, this paper assumes that the decision to set up such

FIGURE 1.1. Summary of Main Considerations in Designing a Financing Facility



Note: CAPEX = capital expenditure; MDBs = multilateral development banks; IMF = International Monetary Fund; OPEX = operational expenditure.

a facility is a policy option that pertains to the relevant sovereign government(s) and policy makers (other private or public agents could in principle pursue similar initiatives, but they are not the focus of this paper).

First, institutional design involves questions of whether the facility is housed at a regional, national, or subnational level; whether it serves multiple sectors or just the water sector; which entity can manage the facility; and the minimum conditions needed for effective stewardship of the funds. Independent of what institutional arrangements are selected for managing the funds, the entity responsible will need to decide on sources of finance for the facility and through which modalities and under what conditions the funds will be dispersed to the utilities.

A second consideration is the sources of finance for the facility which can include government reserves or tax receipts, commercial banks, concessional finance, donor finance (through grants or concessional finance), or a combination of these resources. A third consideration is the modalities of disbursement from the facility, and these could include grants, loans, guarantees, equity investments, or a hybrid model and are different from the funding sources used to create the facility.

Related considerations for disbursement include the scale of support required and how to estimate it, as well as whether to establish eligibility criteria or restrictions on use of funds. The design of a facility also needs to consider what is happening in other sectors, interactions with other financial assistance by government to households and businesses, and the role of regulators, where they exist. Finally, an important consideration is the extent to which a financial facility responding to the crisis can also promote medium-term reforms and help strengthen the financial resilience of the water sector.

Urgent Action Is Required

The essential need to resolve the points laid out in the next chapter of this document cannot be understated. Access to water, especially for handwashing—along with social distancing—has proved to be the most important input in preventing the spread of COVID-19, particularly in high-density, low-income communities. Keeping the taps running at this critical juncture, and expanding access to safe water, can save lives as the pandemic unfolds. Quick action in assessing the need for financing facilities for utilities, and finding the resources to finance them, is perhaps one of the most important actions that policy makers can determine in response to the COVID-19 crisis.

Note

1. In using the term *utility*, this paper focuses on service providers that rely on tariff or fee revenues to cover a substantial portion of their costs, but some aspects of the paper could be adapted for the design of similar facilities for other types of service providers (including nonprofit companies). The term could encompass the full range of service providers, including national water authorities, sub-national/local government entities, irrigation authorities, bulk water providers, private operators, community-based systems, and non-profit companies. The principles laid out in this paper would cover urban, rural, and peri-urban water service providers. Nevertheless, the national and local context of these providers will inevitably influence the scope and design of the facility and should be adjusted accordingly.

Chapter 2

Considerations in the Design of Financial Facilities

The purpose of this chapter is to discuss the key decisions involved in the design of any facility to help water utilities respond to the cash flow impacts of a pandemic and to set out options, advantages, and disadvantages. It describes how factors such as the institutional arrangements, sources of financing, and disbursement modalities should factor into the decisions to create such a facility. The consultation process should include key policy makers from all levels of government, the utilities, potential financiers (public or private), regulators, private operators (as appropriate), and the institution that will be charged with implementing the facility.

Although the focus of the paper is designing emergency facilities to address the COVID-19 pandemic, they could be used more broadly than providing emergency support, meaning they could become a medium-term financing facility for the water sector, if appropriate. If so, it is likely that the emergency phase would focus on supporting urgent operational expenditures (OPEX) and limited capital expenditure (CAPEX) investments, whereas the stabilization phase could focus on supporting institutional, governance, and regulatory measures, and perhaps capital expenditure (CAPEX) investments as well. Facilities that deal solely with the immediate emergencies should consider not only the funding and design criteria laid out in this chapter but also their exit strategy once the financial implications arising from the pandemic stabilize.

Scale of the Financial Support Required for Utilities

In this fast-moving crisis, a first step would be to develop a solid understanding of the impact of the COVID-19 crisis to date, estimate the amount of financing required to keep utilities operating, and ideally expand services to highly vulnerable populations. As the current environment evolves, decision makers will need to assess the medium- to long-term implications for utilities.

Some of the options for assessing the funding required include the following:

- **Existing utility financial models.** Many utilities run financial models to project debt capacity, operating expenses, revenue changes, and so on. Better yet, in some countries, all utilities use a standard financial model for regulatory purposes, so they may only need to be adjusted to project and monitor changes resulting from the pandemic.
- **A World Bank tool created for the purpose.** The World Bank has created a simple financial tool (the “COVID-19 Financial Impact Assessment Tool for Water and Sanitation Providers”)² that sets a baseline before the pandemic affected the utilities operations and enables them to project their (a) revenue; (b) regular operating expenses; (c) emergency expenses, such as additional labor costs, additional chemical costs, new water points, and additional tanker services to address the

pandemic; (d) debt service; and (e) projections on the total monthly cash needed, considering all the above. This tool comes with a manual that utilities can use to estimate the impact of the pandemic on their cash flows. The tool and manual are being translated into Spanish, Portuguese, and French. This option will be most useful if existing models do not exist or a government wishes for a standardized way of estimating impact across all its utilities.

- **Benchmark estimates derived from simple rules of thumb.** At a national level, it may be possible to make simple estimates of the downturn in cash inflows and the increase in expenditures required, based on knowledge of the type and severity of restrictions imposed, economic downturn, and impact of the pandemic. This option will be most important when speed is essential, or if it is not possible to rely on the utilities to forecast needs.

Once the amount of funding required by each utility has been estimated, they can be aggregated to determine the total financial support needed for the sector. Ideally this would be by month, for the probable duration of the crisis and some months beyond. Given the uncertainties involved in the projections, it would be wise to also develop high and low scenarios and to assess the sensitivity of the projections to key underlying variables, such as the level of restrictions imposed or the spread of the pandemic.

Institutional Arrangements

Design of the institutional architecture of the facility and the minimum conditions to ensure proper management of the funds must be considered. Key questions include:

- Will the facility be a national body, or could it be regional or subnational?
- Which entity will manage the facility? Will it be an existing public entity, a quasi-governmental agency (public authority), a nonprofit company, or a private (for-profit) entity? What laws or regulations need to be created or amended to authorize the facility's functions?
- What monitoring and fiduciary arrangements are needed?
- What is the relationship to complementary programs, such as other existing public support mechanisms for water utilities, other sectors, households, businesses, and water sector regulators (which, when they exist, may set pandemic-specific rules limiting disconnections or tariff levels)?

Regional, National, or Subnational

Financial facilities for water utilities could be established at a regional level (covering multiple countries), the national level, or at the level of states or provinces. Although all these options have their place, national-level facilities will likely be the best and most expeditious choice for a majority of countries for a variety of reasons discussed later.

Most facilities will need to find funding in the national budget, borrow from multilateral financial institutions and/or identify resources from other lenders that typically lend only to sovereign governments. Thus, most facilities will be national in their scope, as a regional facility will require individual

negotiations per country as well as agreement amongst them which might lengthen the process. The rules that govern disbursement from a facility (such as how much money a utility can receive or how it must be repaid) will likely differ from one country to the other, making global or regional facilities more challenging to implement.

Nevertheless, small countries may want to consider regional options, particularly when there is a common currency or other effective regional financial and regulatory institutions already in place. As an example, seven small Caribbean countries formed the Organization of Eastern Caribbean States (OECS) and share a single central bank.² Each country has a single water utility, all of which are likely to face similar needs. A single financing facility for a tightly integrated region such as this could be an optimal solution, provided issues of sovereign borrowing, on-lending criteria, and liability for repayment can be worked out.

In federal systems in which states or provinces have responsibility for water (as in Brazil, India, and Nigeria), state-level (as opposed to national) facilities may be considered. This will be most suitable when there are multiple water utilities in each state, the state has the capacity to manage a facility, and there are effective mechanisms through which the federal government can channel resources to state-level facilities (or the state has the financial autonomy and resources to fund the facility directly).

Facility Manager

It will generally be desirable for facilities to be managed by an existing institution, as this will be quicker to prepare. Options may include the following:

- A national development bank (such as Banco Nacional de Desenvolvimento Econômico e Social [BNDES] in Brazil) or water sector financing agency (such as Local Water Utilities Administration [LWUA] in the Philippines);
- A unit in the Ministry of Finance that has experience running government grant or loan schemes and fiscal transfers;
- A line ministry or dedicated sector agency, which may already be managing financial support programs for utilities;
- A bank or professional services firm, operating under contract to the government with strict guidelines and clear responsibilities;
- Commercial banks offering government-guaranteed loans in accordance with rules set by government, again with clear guidelines and responsibilities; and
- A regional development bank or monetary authority (such as the OECS Central Bank or the Caribbean Development Bank) for those cases in which a regional fund is judged to be appropriate.

A key consideration is whether there are already existing financial support programs for utilities that can be adapted as this might be the fastest way for any government to set up a facility (particularly if

they already have allocated funding from the national budget). Because the emergency financial support for utilities is likely to be directed in part to financing OPEX, this may mean enhancing existing fiscal transfers or subsidy programs. For transfers or loans already supporting CAPEX, they would need to be adjusted to enable payment of OPEX under those programs).

The choice will depend primarily on the availability of financial institutions with appropriate capacity and expertise. A significant advantage of using existing institutions include speed and their ability to tap into current operating procedures and capacities. Given the need to make the funds available rapidly, this advantage cannot be understated. On the other hand, an existing institution may not be a good fit if it has a negative reputation or if running a financing facility strays too far from its original mandate. In these instances, it may be appropriate to set up a new institution, in which case a subsequent decision on whether it should continue after the crisis will need to be made. Again, the urgency of the crisis should be considered in setting up a new institution.

Monitoring and Fiduciary Safeguards

Facilities will need to be sure that the money is used and/or repaid as intended. They will certainly need

- Procedures manual;
- Agreements or contracts with the recipient utilities;
- Accounting systems (especially for loans but also for grants);
- Reporting systems;
- Conditionality monitoring processes;
- In the case of loans, banking software that can track timing and amount of disbursements, accrual of interest, grace periods, due dates for repayment, late payments, penalty interest, and the like;
- Clarity on the role of the independent auditor; and
- Clarity on the role of the regulator, or other systems in the absence of a regulator.

Additional considerations include:

- Performance contract between the facility manager and the national government or other providers of finance;
- Ability to monitor and verify (through audits or other instruments) the use of funds by the utilities (if there are to be checks on what the money is spent on, or of compliance with any conditionalities or Key Performance Indicators [KPIs]); and
- Transparency measures, such as making public total amounts disbursed, amounts disbursed to each utility, total amount owed, and late payments.

Relationship to Complementary Programs and Institutions

Questions about the relationship of the facility to related programs also need to be considered. For instance, will the facility be for the water sector only or multisector? If similar arrangements are planned for electricity or other utilities, a multisector facility may be more efficient. On the other hand, given the

unique challenges in delivering water services to the most vulnerable, and the role it plays in combating COVID-19, a stand-alone facility for water may be warranted.

Similarly, what about the relationship to wage support and social welfare programs? Some governments will be providing financial support to households or businesses directly. There is thus a need to consider the relationship between the two types of support—for example, to avoid simultaneously financing water utilities and paying customers' water bills.

Finally, there is a need to consider the relationship to water regulators who may play several roles that a facility will need to be cognizant of, and these include:

- Setting pandemic-specific rules limiting disconnections or tariff levels;
- Creating regulatory mechanisms that make it possible for utilities to repay the liquidity advances after the crisis has passed (if appropriate); and
- Assessing whether utility costs are at efficient levels.

Sources of Finance for a Facility

Six options the government can consider for financing the facility are listed here. It is important to note that the source of finance for the facility is a different issue from the modality of disbursement to the utilities. For instance, a facility could receive loans and then on-grant them to the utilities or on-lend them on different terms than those which the facility received. On-lending and on-granting are covered in the next section. The focus here is on the source and access to the funds needed to create the facility.

Options include the following:

1. **Government reserves or tax receipts** or earmarking a percentage of an existing special revenue tax to flow directly to capitalize the facility.
2. **National government commercial borrowing.** This may include bond issuance by the national government or borrowing from commercial banks (with or without enhancements, such as tax incentives).
3. **Commercial borrowing by the facility with sovereign guarantee.** The facility could borrow money from commercial banks, with a sovereign guarantee, and subsequently on-lend the proceeds to water utilities, such as Financiamiento de Inversiones en Agua (FIA) does in Colombia.
4. **Official credit enhancement of sovereign commercial borrowing.** In this option, the national government would borrow money from capital markets by issuing bonds or borrowing from commercial banks (as in option 2). The government's borrowing would be credit-enhanced by an international agency—for example, guarantees issued by the World Bank Group or other international development banks. The government will typically have to pay a fee for the credit-enhancement provided and may also (depending on the guarantee product) have to indemnify the provider of the credit enhancement against any loss.³ Information about World Bank Group Instruments is provided in Appendix D.

5. **Multilateral/bilateral resources to the national government.** Official lending refers to loans provided by international agencies to governments and may include:
 - Loans from the International Monetary Fund (IMF) to the national government;
 - Loans from multilateral development banks, including the World Bank, to national governments; or
 - Loans from bilateral development banks, typically to national governments.
6. **Concessional finance.** Governments may be able to raise finance as grants from bilateral donors or International Development Association (IDA) credits from the World Bank.

The choice of the source of financing for the facilities will depend largely on the availability of these six options within the national context and the expected fiscal position of the government during and after the pandemic. Under most of the options described, governments have the option to source new financing or to use existing financing through appropriate restructuring. Purely commercial borrowing, if available, is a good solution because it is typically quick and entirely in the government's control. If the situation has led the government to turn to the IMF for support, policy makers could decide to use resources to fund the facility, which could be another quick response.

Financing from development banks typically takes longer to access (unless the existing operation could be used to create the facility) but may have the advantage of coming with technical assistance that can help with the design of the facility itself. Concessional finance is always desirable, but in many cases, only a limited quantity is available to a country, so putting it toward a facility may involve minimizing its impact elsewhere.

Sovereign guarantees of commercial lending to the facility and government borrowing commercially to finance the facility can allow for finance in local currency in some cases. This avoids exchange rate risk. However, these options work only if the national government is itself creditworthy and local financial institutions are liquid. Official guarantees of commercial borrowing by the national government or the facility may reduce borrowing costs or enable access and/or terms to commercial finance that would not otherwise be possible.

Governments will need to decide on the sources of financing and how best to tap them, given their own financial position and policy considerations. They will want a strategy to quickly access the finances needed while ensuring that the potential volume of funding is available at the most beneficial terms.

Modality of Disbursement to Utilities: Grants, Loans, Guarantees, or Equity?

One of the initial and perhaps most difficult policy considerations that will arise in developing a financing facility is whether the financing should be passed to the utility as a grant, loan, guarantee, equity, or some form of hybrid. Given the scale of the emergency, and the fact that access to water can save lives,

grant resources are certainly warranted. Yet few emerging markets have access to unlimited grant resources, fiscal budgets are generally under stress, and deficits need to be kept under control. Thus, the policy considerations surrounding this issue are complex and warrant detailed discussions.

Existing institutions and mechanisms will be influential. If there are already well-functioning loan programs, or if governments are used to transferring grant funds for utility operating expenses, it may make sense to use the same channels. But if existing channels have problems, this may also be an opportunity to reform them.

The decision on the financial mechanism used to convey funds from the facility to the utility is distinct from the decision on the mechanism that funds the facility,⁴ though some funding sources may limit a facility's flexibility. When it comes to conveying funds to the utilities, the basic options are as follows:

- **Grants.** Funds are provided with no expectation that they will be returned to the facility or that the facility will earn interest or dividends on the amounts contributed.
- **Loans.** Funds are provided with a legally binding stipulation that they be repaid, usually with interest. Loans can be designed in a variety of ways—notably, grace periods may be allowed before repayment or payment of interest is required. Loans may also be designed as credit lines, allowing a utility to draw funds up to a limit, repay them at will, and redraw them if necessary. Loans have the benefit of lower fiscal impact for the national government when compared with grants, though they do place a real financial burden on the utilities while also taking more time to design, document, and come to terms of agreement.
- **Guarantees.** Commercial banks (or other financiers) lend to utilities. Repayment of the loans is guaranteed by the facility (in whole or in part). This option is most appropriate when utilities are already accessing commercial loans.
- **Equity.** Equity investments are funds advanced to a company in exchange for an ownership stake in the company (shareholding), which entitles the investor to a share of profits the company earns, dividends, and (typically) a say in the governance of the company.
- **Hybrid models.** These could include elements of the previous instruments. For example, facilities could lend to private water utilities with provision that if the loan cannot be repaid, it converts to equity in the utility; or loans to a utility could convert to grants or equity if the utility meets policy or performance objectives set by the government. A mix of grants, concessional loans, and ordinary loans could also be considered in what is referred to as a blended finance arrangement. Even very small loans on the back of large grants can help utilities gain experience with loan conditions and establish a repayment track record.

Choices on terms and conditions of disbursement will be crucial to success. Health and economic considerations, including the financial capacity and performance of the utilities, will be key factors. A detailed discussion on each option is presented in Appendix C.

Conditions on Disbursements

No matter how the funds are ultimately provided to utilities, policy makers and financing facilities will need to establish the rules that guide disbursements to the service providers, including:

- Which utilities are eligible to receive funds;
- The amount of funds any utility can borrow or be granted; and
- What utilities may spend the funds on.

In the case of loans, they will also need to establish rules on repayment terms, options, conditionality and other considerations that are also detailed in Appendix C.

If national governments are funding or backing the facility, it is likely that decisions on these rules will require input from the Ministry of Finance, the Ministry of Water, and the utilities themselves. The main factors driving the decisions will typically be ensuring that utilities get enough resources to enable them to perform (operate) as needed during the pandemic and in its aftermath. Another consideration will be to minimize the fiscal costs as well as to limit the complexity and time spent in deliberation so that the rules are easy to follow and the money reaches utilities in time. An additional consideration—medium-term improvements in service delivery and efficiency—is discussed in “Promoting Reforms.”

Eligibility Criteria

Facilities will need to define the characteristics that make an entity eligible for financial support. One criterion to consider is the type of entity that may receive funding from the facility—whether any water service provider can apply, how this term is defined, or whether a narrower definition should be adopted.

Another is whether applicants must prove the pandemic has led to reduced revenue and/or increased OPEX and CAPEX. Within this criterion are related considerations about whether a threshold should be defined (for example, a 20 percent reduction or more), what evidence is required, and what expenditures qualify. Tools identified in “Scale of the Financial Support Required for Utilities” could be used for this. For example, a government may decide to provide funding only in cases in which business continuity or service provision is shown to be threatened (that is, there is a cash shortage to pay for direct OPEX, including any additional expenses to supply added services).

A third criterion could be whether water service providers that serve poor or disadvantaged communities, or communities hit particularly hard by the virus, should be prioritized in receiving funds. For instance, in a country with several urban utilities, one that serves a city where the pandemic is severest may receive priority funding.

Other criteria could include adoption of health and safety measures to protect the utility workers, preparation of business plans to respond to the pandemic, or adoption of contingency plans, etc.

Amount to Be Provided to Each Utility

Having decided that an entity is eligible for support, the next question will be the amount of funding to provide. There are three broad options:

- **Deterioration in cash flow caused by the pandemic.** This measure would consider the combined effect of reduced cash collections from customers, and any increased expenditures necessitated by the emergency, to provide funds equal to that amount. The main advantage of this approach is that it relates funding provided to the utility directly to the impact of the pandemic. The main disadvantage is it may not provide enough funds if a utility was lacking funds even before the pandemic, or conversely, it may provide more funds than needed if the utility had a preexisting surplus.
- **Funds needed to keep operating, regardless of the cause.** This approach differs from the preceding one in that it does not inquire as to whether the funding need was caused directly by the pandemic. A utility that did not have enough money to operate before the pandemic could, in effect, have that preexisting deficit covered by the facility. Conversely, a utility in a strong cash flow position before the pandemic would not get funding equal to the impact of the pandemic on its cash flows but would be expected to absorb some of it using its preexisting cash surplus. A disadvantage is the financial calculations would be more complex and controversial, especially considering prevailing inefficiencies and the extent to which those should be funded.
- **Funds needed to cover essential expenditures.** This approach would simply define the categories of expenditure considered to be essential for continuity of service provision (including normal expenditures—such as wages and salaries, electricity, and chemicals—plus additional special social and health-related service provision obligations placed on the utility by the government) and provide funding equal to historical expenditure on these items. This approach is the simplest but likely also the most fiscally constraining as it is the most broad-based.

Restrictions on Use of Funds

Governments will need to decide whether to try to establish controls on the use of the funds provided by financial facilities. At the highest level, there are two options: limit how the funds are spent or not. If the former, decisions will be needed on what these limits should be.

There are good reasons for not limiting what the money disbursed from the facility may be spent on, including the following:

- Utilities will typically already be subject to rules that require them to spend funds only on utility purposes and in the best interests of the utility or the public.
- There will be many demands on utilities' funds, and the managers in the field are better placed than officials in a facility to know what the immediate priorities are.
- Putting in place rules and restrictions takes time, and any delays in disbursing the money may cost lives.

- If limits are put on what the money can be spent on, monitoring and auditing systems will be needed to check that these limits are respected, which takes time and money to create and even then, may not work well.

Equally, there may be good reasons for specifying limits on what proceeds may be spent on, perhaps especially when funds are provided by a grant. Key among them is the risk of misguided policy, rent-seeking, corruption, theft, or the power of vested interests. The public may demand that funds are spent only for specific purposes, requiring these purposes to be defined. For many utilities, much of their cash flow for several months may derive from a facility. As the quantity of other funds available diminishes, the practical efficacy of limiting what the funds may be used for increases. Categories of permitted expenditure could be defined quickly, whereas existing monitoring systems—such as external auditors—could be adapted to track compliance with the rules.

Another reason is to secure funding for priority expenditures given social and operational considerations, which may not be prioritized by the utility otherwise. If limits are set on what funds may be spent on, the following categories of expenditure would be suitable for inclusion in most cases: expenditure to protect utility staff from infection, expenditure to protect customers from infection, emergency water supplies to vulnerable communities, wage and salary expenditures, other essential operating expenditures (chemicals, electricity, and administrative expenditures), and urgent repairs and maintenance. Others may include, depending on local conditions and priorities and possibly subject to caps, backlog repairs and maintenance (to the extent this is needed for the crisis response), debt service (unnecessary if lenders agree to restructure their loans), and major capital projects (which could provide economic stimulus).

Decisions on what the funds may be spent on should be guided by assessment of what type of expenditure will be most needed given social, health, operational, and other considerations; what scale of funds will be provided and conditions will be put in place; and the ability to monitor and enforce the restrictions imposed.

Promoting Reforms

Should financial facilities attempt to promote utility reforms? The water sector may not typically get the attention it warrants from the ministries of finance. The COVID-19 crisis puts the water sector front and center, both because of its importance in the fight against the pandemic and its need for fiscal support. It thus creates a rare opportunity to engage with stakeholders who may support vital reforms, including achievement of universal access, service quality, efficiency, and financial viability. There is little doubt that many utilities could do better by emulating reforms to tariffs, finance, governance, and management, which have been proven to work in other utilities over decades.

That being said, the overriding aim of financial facilities' setup in response to the pandemic must be to quickly get money to utilities—in sufficient quantities—to allow them to keep functioning as their cash

receipts plummet. Without doubting the need to reshape the ways of water utilities, or the importance of utilities becoming radically more effective after the crisis, the question must be asked: Is a financial facility the appropriate tool for the reform agenda?

The advantage of attaching reform requirements to assistance from a facility is that, if it works, water utility service would improve, and efficiency would increase. It seems reasonable that poorly performing utilities in receipt of public assistance should be expected to do all they can to improve. In cases when the facility is providing loans, water utility performance improvements would also make it more likely that loans from the facility would be repaid. The disadvantage is it may be difficult to design and get support for policy reforms given the urgency of the funding needs and the critical need for water services in response to the pandemic.

The choice does not need to be either/or. Another option is for facilities to first disburse funds as grants or loans without policy conditions or with limited conditionality. Then, as the crisis subsides, reform programs could be designed, and utilities offered deferral or forgiveness of the sums borrowed if they implement the reforms.

Where Adding Policy Conditionalities Would Be Appropriate

To achieve reform objectives, policy conditions could be attached to financial assistance from the facility so that utilities would have to commit to making reforms. Such an exchange would create an opportunity to bring fresh perspectives and powerful stakeholders, such as finance ministries, to chart a better direction for the water sector.

The desirability of attaching policy considerations and conditionalities to disbursements from a facility will depend on prevailing conditions, both how urgent the need for resources are and the extent to which there is already consensus on reforms. In urgent cases, or if quick consensus on reforms is unlikely, adding policy conditionalities may not be appropriate. Table 2.1 describes factors that would

TABLE 2.1. Conditions that Are Favorable or Not Favorable for Reform

Favorable for reform conditions	Reform conditionalities could backfire
Preexisting consensus among stakeholders on the reform direction needed	Lack of clarity on reforms needed Disagreement between key stakeholders on need for, or direction of, reform
Senior officials and ministers from relevant agencies (including the Ministry of Finance) can devote time to agreeing to reform conditionalities, and they are expected to be able to agree quickly	Senior officials and ministers cannot spend enough time or agree quickly enough, causing significant delays to the design of the facility and hence disbursement of funds
Administrative capacity is sufficient to quickly explain policy conditionalities to utilities and incorporate the conditions in financial support documents	Low capacity means that explaining and documenting the reform conditionalities will significantly slow disbursement of funds
Utilities genuinely agree with the reform conditions, having had time to consider them	Utilities do not agree with reform conditions or have not had to time to consider them but sign anyway, feeling coerced

tend to promote the success of policy conditionality and, conversely, situations that militate against policy conditionalities.

For conditions as described in the right column, an emergency-only design may be appropriate. Conditions in the left column will lend themselves to an *emergency plus stabilization* design.

- **Emergency-only design.** An emergency-only financial facility would have just one function: providing liquidity as needed and pursuing repayment later (if it is a loan; if it is a grant, no repayment would be expected). This type of facility would need conditions related to monitoring and use of the funds but would not seek reform of the utilities. This is not to say reform would not be sought, only that the facility itself would not be the vehicle to pursue this.
- **Emergency plus stabilization design.** An *emergency plus stabilization* financial facility would have the capacity for a second phase—one with policy reforms—after the initial liquidity. This would always include the emergency fiduciary conditions as well as add other policy-related conditions to come into effect as the crisis eases.

Two types of *emergency plus stabilization* designs can be considered:

- **Preexisting.** Where an existing program with reform measures has been agreed, it can provide the basis for conditionalities for the facility. This occurs when a government and/or donor (multilateral or bilateral) has an existing reform program in place with a utility or at the national or regional level.
- **Newly developed.** As management energies and time become available after the initial crisis, reform plans can be developed. The financing facility can incentivize and assist utilities to follow the reform program by offering deferral or forgiveness of debt already incurred or by offering additional funding for post COVID-19 investments.

By What Means the *Emergency Plus Stabilization* Design Can Promote Reform

There are various ways in which an *emergency plus stabilization* design with policy conditionalities can promote reform. The basic idea would be that utilities would agree to the reform conditions to access two benefits:

- Funding under the first phase, meaning quick disbursement of emergency funds to keep the utility running; and
- Additional financial assistance to implement the reform program provided under the second phase.

Governments adopting an *emergency plus stabilization* design will need to decide which reforms to promote. Directions to consider include the following:

- Reforms linked to the efficiency/creditworthiness agenda. Governments will want utilities to be able to operate more efficiently and repay at least some of the liquidity funds. There will also be a strong desire to move toward financial self-sufficiency, considering the fiscal stress that most governments will be under after the crisis.

- Using the Utility of the Future framework⁵ to chart a course toward improvement on multiple fronts—not just financial and service but also crucially increased resilience and sustainability through embracing new technologies and management methods.

The reform direction would have to be described, with milestones articulated clearly enough to allow an objective judgment on whether they have been reached. Successful completion would trigger additional financial assistance in a second round of support (potentially in collaboration with a donor). Milestones will generally be of two types:

- **Actions.** Things the utility must achieve. These may range from managerial matters (such as installing a new billing system or implementing a nonrevenue water reduction program) to governance changes (such as how the board operates) to more fundamental changes such as amalgamations, restructuring, or attracting outside management or investors to the utility.
- **Performance.** Results the utility has to achieve. They would typically be specified through a set of KPIs, which could cover things such as coverage, service quality, efficiency, or profitability.

Options for the financial incentives triggered by reaching these milestones include:

- Additional funds from the facility;
- Deferral of repayment of debts incurred in the first phase, if relevant; and
- Forgiveness of debts incurred in the first phase, if relevant.

If a multilateral agency has provided financing for the financial facility, it may wish to work with the government on the *emergency plus stabilization* reform program (see reference to the Multiphase Programmatic Approach (MPA) in Appendix D). This may include providing technical assistance on design of the program and assisting with the incentive elements of the program by arranging for loan forgiveness or deferral or provision of post crisis financing for development. The possibility of such arrangements should be considered when deciding on the appropriate financial operation for the multilateral agency to use.

Although milestones would often be agreed upon before funds are disbursed, given the time that this may take and the urgency of the situation, it is worth noting that governments could adopt what could be called a *delayed stabilization design*. Here, the facilities would disburse funds as loans without policy conditions attached.⁶ Then, as the crisis subsides, reform programs could be designed, and utilities offered deferral or forgiveness of the sums borrowed if they implement the reforms. The advantage here is speed. The disadvantage is less momentum to make the desired reforms.

Notes

1. <https://www.worldbank.org/en/programs/global-water-security-sanitation-partnership/publication/financing-universal-water-and-sanitation-services-covid>.
2. Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.
3. *Indemnity* means something a sovereign has to sign to get a World Bank guarantee of the sovereign's obligation to a third party. It provides that if the World Bank suffers any costs, the sovereign will compensate the World Bank for its costs. Such credit enhancement can also be

used in conjunction with option 3; as an example, the official credit enhancement could guarantee the facility's repayment to the commercial lender while the national government could then indemnify the provider of the official credit enhancement.

4. For example, a government could grant funds to a facility for on-lending to utilities, or a government could borrow money from the IMF, put the funds in a facility, and direct the facility to provide grants to the utilities.
5. The Utility of the Future framework is composed of a methodology and Excel-based tool for diagnosing utility performance, maturity, and action planning. It sets out practices that well-performing utilities have in the areas of commercial operations, technical operations, human resources management, financial management, organization and strategy, resilience, innovation, inclusion, and market and customer orientation.
6. The paper does not go into great depth in terms of financing the stabilization phase of the program because of the urgent need for resources during this emergency phase. However, the World Bank and other International Finance Institutions and donors have a great deal of experience in designing, implementing, and financing stabilization-like activities, and those could be used. Blending with private sector resources—either through debt, equity, or guarantees—is also part of this approach, and the options of tax incentives to attract this private investment is also included in the array of financing mechanisms.

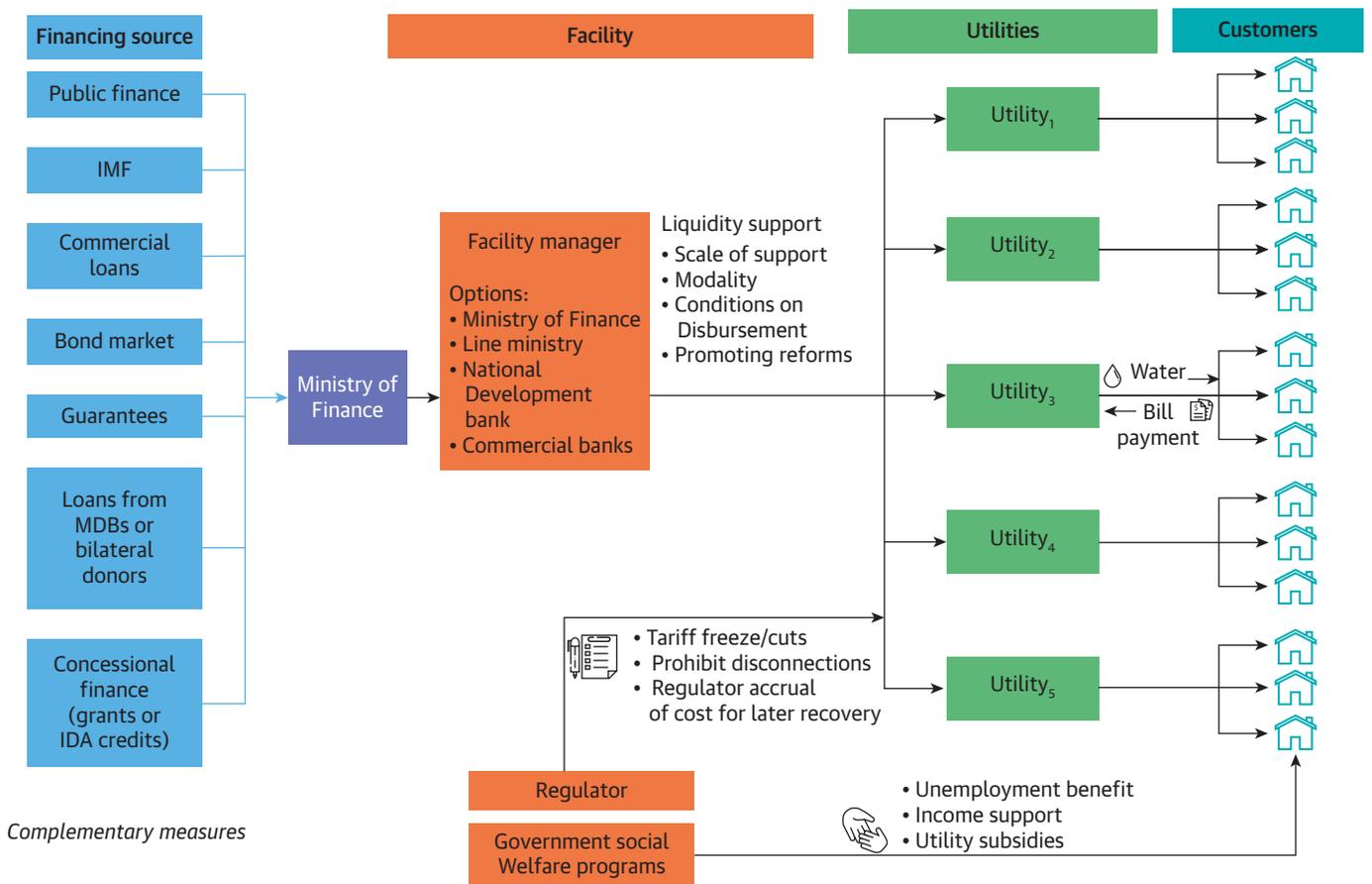
Chapter 3

Conclusions

The objective of a facility is, above all, to enable water utilities to fulfill their frontline function in the fight against COVID-19 infection, even as their cash receipts drop and demands for emergency expenditure grow. Figure 3.1 brings all the elements discussed in Chapter 2 together, showing how funds flow from the sources to the facility (often through the Ministry of Finance) to the utilities, all for the benefit of good water supply services for the customers.

In designing such a facility, the first step is to estimate utilities' emergency financing needs. There are a variety of ways to do this, including with the aid of the "COVID Financial Impact Assessment Tool for Water and Sanitation Providers" designed by the World Bank. Forecasts from this and other tools at a utility level can be aggregated to estimate the financing needed at a national level. Sensitivities and

FIGURE 3.1. Flow of Funds



Note: IMF = International Monetary Fund.

scenarios should be considered, given how uncertain the situation is. Regardless of the instrument used, quantifying the scope of the problem is a critical first step. The ability to monitor and update information related to the size of the financing gap as the pandemic unfolds is a critical dimension of this process.

With aggregate financing needs established, the next question will be the source of funds to finance the facility. Existing government funds or reserves can be used if available, and credit-worthy governments can borrow in the capital market. However, many developing countries will turn to official financiers, including the International Monetary Fund (IMF), the World Bank, and others, particularly in view of the economic and fiscal stress the pandemic is causing globally. In addition to sovereign borrowing, credit enhancement of commercial borrowing by the World Bank and others is an option, as shown on the left side of figure 3.1. Because in most cases the financing of the facility will be underwritten by the national government, the Ministry of Finance is shown as the conduit of these funds to the facility.

Continuing to read across figure 3.1 from left to right, it is clear that a facility manager is needed. Given the urgency of the situation, an existing institution can play this role. Options will vary from country to country but may include a unit in the Ministry of Finance, a national development bank, a line ministry, or a commercial bank operating under a contractual arrangement with the government. The facility will generally be a national entity, though regional or state-level entities may be an option in some cases. Wherever the facility is housed, minimum conditions for effectiveness will include process manuals; software to keep track of grants and/or loans; monitoring; auditing and transparency provisions; and proper legal documentation for all financial transactions. Although speed is critical in terms of getting resources to water service providers, it is equally important to clearly establish the “rules of the game.”

This includes the conditions on which funds are disbursed to utilities. The Ministry of Finance, Ministry of Water, and utilities themselves will typically be involved in setting these rules. A fundamental question is whether funds will be disbursed as grants, loans, or some other form. Although grants may be the fastest and provide the most help to utilities, loans have the advantage of reducing the overall fiscal cost of the program. This balance between speed and fiscal responsibility may be the single biggest consideration policy makers need to address. Criteria, whether grants, loans, or both, will be needed to determine which entities are eligible, how much funding they may receive, and on what they may spend the proceeds. If loans are used, interest rates and repayment terms will need to be set. Concessional interest rates might provide the greatest financial support but will also increase fiscal costs. High-interest rates, with all their other issues, would ensure that utilities do not borrow more than they need and that they pay it back as soon as they can.

Although the crisis is a threat to water utilities, it may also be a springboard to their reform. The present moment may be a rare opportunity to focus high-level political attention on the water sector given its importance for public health and its need for fiscal support. Whether a financial facility can play a role in promoting reform depends very much on local conditions. If there is already a reform plan in place, or if consensus on reform can be quickly reached, commitment to it can be made a condition of disbursement from the facility. Where these conditions hold, an *emergency plus stabilization* facility design

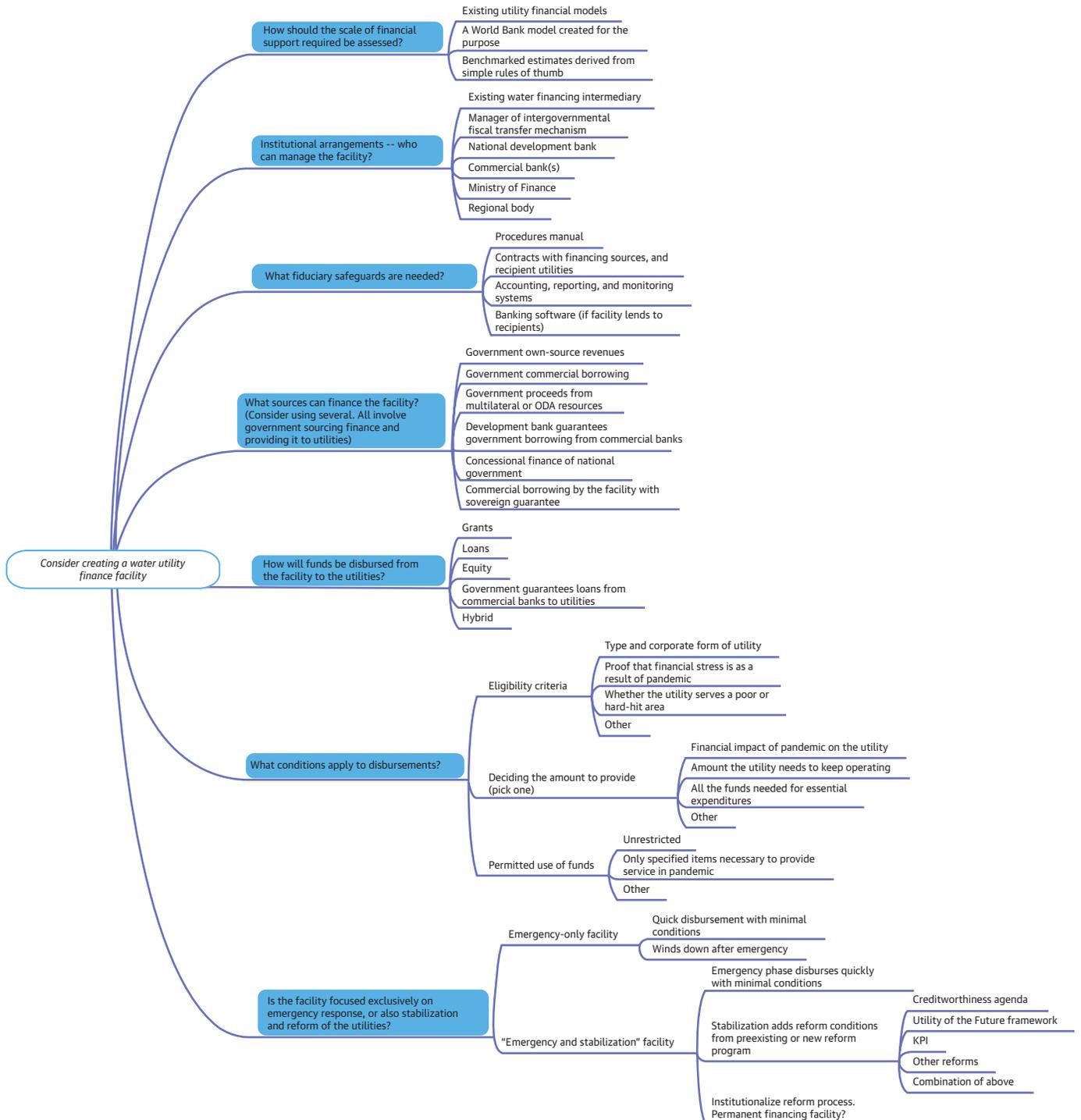
could follow an initial shot of liquidity with further financial assistance provided as reforms progress. On the other hand, if quick agreement on reform direction is not likely, attempting to tie facility disbursements may do nothing but delay the provision of urgently needed funding.

The design of a facility also needs to consider what is happening in other sectors, interactions with government financial assistance to households and businesses, and the role of regulators. Water sector regulators are important because their decisions will influence utilities' cash receipts during the crisis (for example, by limiting tariffs and disconnections) and can also enable utilities to repay loans by setting tariffs appropriately in the future.

In making all these design decisions, a proper appreciation of the need for speed is vital. There are many difficult trade-offs between, for example, the risk of utilities not getting enough money and the fiscal cost of providing the resources. Numerous options are available at each point in the process, and close analysis could lead to technically better decisions. Ultimately policy makers will need to weigh the various options laid out in this document and, based on local considerations referred to earlier, make decisions based on their needs, resources, and implementing environments.

Yet if such close analysis delays the creation of the facilities and disbursement of funds, it is imperative to reiterate that there will be costs in terms of water service provision and individuals' ability to protect themselves against the pandemic. Policy makers will be required to make bold and quick decisions based on limited information if the financing facilities are to succeed in keeping water utilities fully operational on the frontline of defense against the COVID-19 pandemic.

Appendix A Decision Tree



Note: IMF = International Monetary Fund; KPI = Key Performance Indicator.

Appendix B

Advantages and Disadvantages of Disbursement Modalities

As set out in “Modality of Disbursement to Utilities” in Chapter 2, one of the initial and perhaps most difficult policy considerations that will arise in developing a financing facility is how to disburse the money to the utilities. Five main options are a grant, loan, guarantee, equity, or some form of hybrid. The advantages and disadvantages of each option are presented here.

Grants

In the midst of a global public health crisis, there is certainly a rationale for providing the resources as a grant and distributing funds widely to all affected utilities with no repayment clauses. If there is no reasonable expectation that the utility can return the capital at any time in the foreseeable future, a grant may well be warranted.

The practical benefits of grants are clear. They are fast disbursing and relatively simple to design. Although a monitoring system should be put in place, the system will measure the impact of the financing facility on service delivery rather than closely monitor the financing terms, making the monitoring system simpler. A grant would be the preferred option for any utility manager. It is also the most empathetic way to address the crisis.

But there are both costs and lost opportunities by using a strictly grant based approach, particularly when considering that the COVID-19 pandemic is not just a health crisis, but also a global economic crisis. Although the long-term repercussions on the health of national economies is not yet clear, the fact that more than 100 nations have put IMF agreements in place is an indication of the scale of the economic crisis. Governments’ fiscal resources will be strained. Ministries of Finance will insist on minimizing demands on the budget where possible.

Although the source of resources to the financing facility is distinct from the on-lending or on-granting arrangement to the utilities, there are important public finance considerations. If most of the money flowing to facilities originates as loans, but the money from the facility is disbursed as grants, the inescapable corollary is that the national government will have to repay the loans from general tax revenues. For countries facing GDP declines of five percent or more, the reduction in tax revenues, coupled with the increase in social spending, will create severe fiscal stress, plausibly worsening the budget deficit by about 2 to 3 percent of GDP.¹ Assuming additional debt will be most unwelcome. On the other hand, in instances when the users of the facility can repay the facility, this stress can be avoided.

In this context, the main disadvantage of grants is that they maximize the negative fiscal impact on the national budget; if the government borrows money to fund the facility, but the facility disburses grants, the government will absorb these costs and repay the loan out of future tax revenues.

This debate is further complicated by realities in the water sector. Research shows that, in many countries, the households served by water utilities tend to be higher income households than those not served. Grants to water utilities risk subsidizing the better off, compared with a scheme in which customers ultimately must repay the facility through their tariffs. Finally, providing funds as grants may miss an opportunity to promote reforms and performance improvements because the leverage for promoting such improvements maybe reduced once funds have been unconditionally disbursed.

Given these complexities, the terms of disbursements from the facility to the utilities is arguably one of the most pressing and challenging decisions in this entire process.

Loans

A primary function of the facility will be to provide liquidity to water utilities. The premise of a financing facility is that the business is fundamentally viable but suffering from a temporary shortfall in cash.

This premise might seem questionable considering the number of developing country water utilities that have run operating losses for many years. Yet the operating losses water utilities suffer are not a reflection of the fundamental economic realities, but of policy and implementation failures that create an unwillingness to charge cost recovery tariffs, or efficiently enforce collection of unpaid tariffs, or governance structures that countenance inefficient practices. In the long run, governments can and must ensure that water utilities are financially viable—either through policies that promote efficient provision and cost-recovery tariffs, or through ongoing transparent fiscal transfers to bridge the gap between costs and revenues.

Many water utilities can and do repay loans. Many more *could* repay loans, if appropriate steps were taken to increase efficiency and charge cost-reflective tariffs. Water is a product for which customers are willing and able to pay; at least operating costs and, in many instances, long-term capital costs as well. As further developed in “Promoting Reforms” in Chapter 2, loans can be combined with policy measures to improve utility performance. These policy measures can improve service delivery while also increasing the chance of the loan being repaid through technical and financial efficiencies and expanded services.

Loans, to be effective in providing liquidity, would have to be appropriately structured. Likewise, policies need to be considered, and this does take time. Usually, liquidity facilities are short term in nature, but it would not make sense to require utilities to start servicing the liquidity debt while they are still suffering from cash flow reductions caused by the pandemic. Long grace periods for repayment of both principal and interest need to be considered, and provisions for redrawing principal earlier repaid, could also be incorporated into loan design.

By using well-structured loans, facilities may avoid the fiscal impact of grants on the national government. Repayment of loans by water utilities will reduce the fiscal costs of the operation of the facility because the burden on the national government to repay loans or provide funds directly will be reduced.

Yet there is a very real cost to the service providers. The disadvantage of loans, compared with grants, is that they place a real financial burden on the utilities while also taking more time to design, document, and come to terms of agreement. With loans, effort must also be expended in monitoring the borrower and ensuring the collection of interest and repayment of principal. In the event of a default, the facility will also have to expend time and effort to manage the “work out” process so the utility can start repaying their loan obligation. The facility must be careful not to overburden utilities with liabilities they cannot hope to service in the future. Given the problem of moral hazard (lack of incentive to guard against risk when one is protected from its consequences), it would not be wise to forgive debt service simply because the utility cannot pay, as this could make the utility unlikely to try to service its debt in the future.

Guarantees

Instead of lending to the utility itself, the facility may guarantee commercial loans, bonds, or other instruments to the utility. In this option, the cash the utility needs would be provided by a commercial bank (or possibly a bond issuance). The facility would promise that, if the utility does not pay, the facility would service the loan. The guarantee could cover the entirety of the amount owed, or just a part (known as a Partial Credit Guarantee). A government guarantee of commercial loans to utilities would be similar to the business-continuity loan guarantee programs instituted for business generally in places such as the United States, Australia, and New Zealand.

Guarantee programs will be advantageous when utilities already have relationships with commercial financiers. Rather than disrupt existing commercial lending relationships by coming in as a new lender, a facility can support those existing relationships. A guarantee would enable existing lenders to provide additional financing in cases when, because of increased risk, they otherwise would not.

Even if utilities are not currently borrowing from commercial banks, a guarantee program could have some advantages. Some banks will have branches all over the country, and the skills and software needed to process loan applications, disburse funds, and later collect debt-service payments. By using this existing financial infrastructure, a facility can reduce the need to invest in its own systems and recruit and train staff. This option may be particularly valuable in countries with many water utilities spread all over the country. Another advantage may be that utilities and banks will get used to dealing with one another, which in some cases could spur greater use of commercial finance by utilities after the crisis subsides.

The main disadvantages of using guarantees of commercial lending stem from the complexity of dealing with another party. If the facility lends money, it simply needs a loan agreement with the utility. If the facility guarantees a third-party’s loan, it may create more complicated commercial relationships, and distance the facility from the utilities it is seeking to serve. Difficulties may also arise later, if the utility does not repay the loan, and the facility considers that the lender was imprudent in its lending decision, or lax in enforcing payment and monitoring.

Equity

Most applicable in situations in which the water utility is already partly or fully privately owned, the facility could provide a utility with funds in exchange for shares in the utility. Shares would normally give the shareholders a right to influence the management of the company by electing or being represented on its Board, and a right to participate in future profits of the utility, when applicable.

If equity in the water company is partly or privately owned (as, for example, in SABESP,² or in the concessionaire responsible for water supplies in Bucharest, or in Côte d'Ivoire), equity contributions are clearly possible, if agreed to by the utility. Equity could also be considered if there is a medium- to long-term objective of privatizing the utility. The advantages of an equity contribution are that the utility never has to return the money, or to pay any set interest rate on the money received, making equity an effective liquidity mechanism. At the same time, the facility may be able to recover some or all its investment, through future dividends on the shares, or by selling its shareholding once the crisis has passed.

A key disadvantage of this option is that the terms of the equity investment may be difficult and time-consuming to negotiate. Agreement on what percent of the shares the equity investor gets in exchange for the investment may be difficult to reach. Another risk is that increasing public sector control of the utility may open the door to political economy dynamics that can worsen governance and performance.

For water utilities which are fully publicly owned already, the considerations may be different. Many public utilities are not legally incorporated as companies with shareholders, creating a practical difficulty to structuring disbursements as equity. More fundamentally, if all the equity is already owned by government, then providing more equity will not increase control or leverage.

In these circumstances, a further disadvantage of structuring disbursements as 'equity' is that it may obscure the costs of the operation. If the money disbursed will be given to the utility with no expectation of financial return to the facility or the government, it is, in effect, a grant. Yet depending on the public sector accounting rules used, it may be accounted for differently, understating the true fiscal costs of the program.

Hybrid Models

Any number of hybrid models combining various elements of grants, loans, and equity are possible. Three, which are worthy of consideration, include:

- **Loan-grant hybrids.** In this model, disbursements would be provided partly as a loan and partly a grant. The grant amount might be specified in advance, and perhaps calculated at a level which made it likely that the utility would, in future, be able to service the part disbursed as debt. Alternatively, the loan component might be stated from the start to be potentially forgivable (that is, converted into a grant), dependent on certain conditions. These conditions might be needs based (for example, if the financial impact on the utility was worse than expected) or policy based (if the utility in the future adopts certain reforms or meets specified performance targets—see

“Promoting Reforms”). Yet another approach could be to set the grant to cover just the cost of one-off social/health mandates imposed on the utility by government (free water to those who cannot pay, reconnection expenses, increased water tankering, set up of public handwashing facilities, and so on). The loan part could cover more long-lived lower revenues and higher operating costs.

- **Debt-equity hybrids (Convertible Bond/Loan).** In the case of utilities, which are (wholly or partly) privately owned, the facility could offer loans on terms that would allow the loan to be converted to equity in the event of nonpayment. This would enable and encourage the existing owners to manage their way through the crisis effectively while maximizing government leverage if they do not.
- **Debt-debt hybrids.** The utility would receive two loans, one from the facility and one from a commercial bank. The two loans may be on the same terms or, to encourage commercial bank lending, the loan from the facility could be at a lower interest rate or subordinated to the loan from the commercial bank (blended finance).

Notes

1. If the tax take is 20 to 30 percent of GDP and the increased expenditure is 1 to 2 percent of GDP.
2. The utility serving the state of São Paulo in Brazil.

Appendix C

Options and Considerations for Loan Terms

If it has been decided that the facility should disburse funds in the form of loans, decisions will be needed on the terms of the loan, including grace periods, repayment terms, rights to refinance, interest rates, currency of the loan, and security. These points will also be influenced by local institutional, governance, regulator and financial arrangements as well as the scale and scope of the pandemic. Here are some of the important details, which policy makers should consider, in consultation with the borrowers, if loans are being used, regardless of the source of those loan funds.

Grace Periods

A grace period is a period after the loan is drawn down and before payment on the debt starts. Grace periods may be just for principal (in which case only interest is paid) or for both interest and principal.

Because the aim of the loan will be to help utilities continue functioning during a period of reduced cash flow, it would be counter-productive to require payment of debt service during the crisis period. In principle, loans from a facility should come with a grace period on both principle and interest long enough for utilities to have a chance to recover from COVID-19 impacts before they start having to repay.

Term

The term of the loan is the period over which it must be repaid. Related considerations include the rate of repayment of the principal, and whether the principal can be redrawn (meaning the utility can draw down principal it previously had repaid, in the event more funds are required in the future).

Generally speaking, the longer the term of the loan, the lower the repayment in each period. This suggests a term that should be long enough to keep debt-service payments at a level that utilities could be expected to cover from their operating cash flow generated in the ‘new normal’ future. That is, after the pandemic is over, the economy has recovered, and any improvement plans that have been agreed are implemented (see “Promoting Reforms”), the utility should be able to generate positive cash flow from operations. At least in principle, this could be estimated, and the loan term set so that annual repayments are slightly below the forecast level of free cash from operations. Because many utilities will take time to recover, and even then, may not generate large sums of cash from operations, utilities will generally benefit from relatively long loan tenors. Set against this will be the benefits of shorter tenors, which by returning funds to the facility more quickly could (depending on the structure of the facility) allow government to reduce public sector debt more quickly.

Given the unpredictable nature of the crisis and hence of utility financing needs, it could be beneficial to allow utilities freedom to pay down the loans as quickly as they like (for example, if the recovery is faster than anticipated), and also to redraw on money paid down (if necessitated by a second wave of infection,

for example). In this case the loan could be structured as a credit line, rather than a conventional loan. One disadvantage of a credit-line structure (which also applies in cases in which loans may be converted into grant or equity) is that the facility will have no certainty when it will be repaid, which might cause difficulties when the facility comes to repay its own creditors. Another is that it may reduce financial discipline on the utility, if repayments can be delayed or indeed withdrawn.

Interest Rates

Loans from the facility may bear interest. The rates charged could be:

- **Subsidized:** lower than the interest rate at which the facility itself pays for its funds, or lower than the usual government cost of borrowing;
- **Pass through:** equal to the interest rate at which the facility borrows (possibly with a “small” mark-up for the administrative costs of the facility);
- **At market:** interest rates in line with rates utilities can borrow at in normal times.¹ For utilities that borrow commercially without a government guarantee, this interest rate is observable. For those utilities that do not borrow commercially, this is something of a theoretical construct. Even so, it may be a useful approach as a thought experiment: ‘if market conditions returned to normal, and this utility implemented a plausible reform plan that made it credit-worthy, what interest rate could it borrow at?’; or
- **Above market:** higher than the rates at which utilities can be expected to borrow in normal times.

The advantage of a subsidized interest rate is obviously that it will make it easier for the utility to recover after the pandemic because the amount of cash the utility must pay to the facility each period will be less. Another advantage is the perception or reality that no one should benefit from a crisis and that rates should be below market, wherever possible. The clear disadvantage is that this increases the fiscal cost. If the interest rate paid to the facility is less than the rate the utility pays on its funds, the difference will have to be covered by the national government.

A pass-through interest rate would overcome this disadvantage because the utilities would pay the same rate at which the facility, or the government in general, could borrow. Administrative costs of the facility could be covered through a mark-up on the interest rate. One disadvantage of the pass-through option, compared with an option that charges a higher than market interest rate, is the facility would still have a net fiscal cost (because to break even, the facility would need all utilities to repay their loans in full; but in reality, it is likely some utilities default on their loans). This option also assumes that the borrowing from the facility is in the same currency, thereby eliminating the foreign exchange risk. Another disadvantage of the pass-through option is it could crowd out market-based lending because rates offered by the facility could be lower than those offered directly to utilities by commercial banks.²

At market rates would have the advantages of reducing further the total fiscal cost of the facility (because more money would flow to the facility from the utilities than in the other options). It would also reduce the risk of crowding out other financing sources. However, the burden on the utility would be commensurately higher.

Lending above market rates might seem a counter-intuitive response to a crisis. It could even give rise to profiteering from a crisis. The main advantage of lending at above market rates is to ensure that utilities do not borrow more than they need, and that they repay as soon as possible including by refinancing loans from the facility with lower rate loans available from other lenders. This option minimizes the size of the facility, minimizes total fiscal costs, and eliminates the risk of crowding out other sources of finance.

Currency

The loans can be denominated either in local currency, or in an international currency, such as the U.S. dollar. Because water utilities tariffs are fixed in local currency, borrowing in foreign currency creates a foreign exchange risk. If the local currency was to depreciate against the foreign currency after the loan was given, the local currency cost of servicing the debt could grow unpredictably, and perhaps significantly. The 1990 Asian currency crisis, and devaluation of the Argentinian peso, led to ballooning local currency debt-service costs, which bankrupted several utilities. From the utilities' perspective, the less risky option will be loans in local currency.

A disadvantage of the facility lending in local currency to utilities would arise when the financing facility itself was financed in foreign exchange but, in turn, lending in local currency. In this case the disadvantage (foreign exchange risk) falls to the facility, and presumably the government, rather than the utility.

Thus, if possible, the facility itself should borrow in local currency. Unfortunately, the main sources of funding for facilities will be official lenders, such as the IMF and international development banks, and the range of currencies in which they can lend is quite narrow. If official funds in local currency are not available, financial engineering strategies could be explored.

Another intriguing possibility would be for the facility to borrow in local currency from commercial banks, with a guarantee of repayment provided by the World Bank Group (including IFC or MIGA), another MDB, a private guarantor, or a bilateral (for example, AFD, USAID or SIDA). Although the guarantee might have to be denominated in hard currency, if the exchange rate depreciates, the guaranteed amount would exceed the value of the funds lent (which would not create a problem). On the other hand, if the exchange rate appreciated, it would likely be a sign of a healthy economy, meaning the probability that the government would default on the loan would be low.

Security

There are several options for providing security of repayment from utilities to the facility. These include:

- Guarantees from local, provincial, or state governments;
- The ability to intercept government grants to the utility, or an associated municipality, and apply the proceeds to service the debt, if legally authorized;
- The ability to impose a revenue escrow account on the utility. This would mean that the revenues would be paid into a bank account controlled by a neutral third party (the escrow agent). This neutral agent would then pay the facility the debt service owed, before remitting the remainder of the funds to the utility for operations (gross pledge of revenues);
- Charges over the assets of the utility, including its receivables, equipment, land, buildings, and infrastructure assets, if legally authorized. Such charges would have the effect of passing ownership of the assets to the facility if the debt was not paid; and
- The ability to take over ownership, partial ownership, or decision-making powers on the board.

The main advantages of including such security arrangements would be to increase the likelihood of the funds being repaid, thus reducing the overall fiscal costs of the operation. Other possible advantages would be to increase financial discipline on the utilities, and possibly pave the way for future reforms and restructuring. As an example, if the facility took over the assets of utilities, which did not repay, it could restructure them, bringing in more effective management, merging neighboring utilities that lacked scale, or bringing specialized private operators under lease or concession contracts.

Against these advantages must be weighed the cost and complexity of creating and legally authorizing them, the likelihood that they would be effective in practice, and whether there would be a political willingness in the future use the mechanisms created. These are quite significant and should be weighed carefully against the potential advantages.

Terms Differentiated by Category of Utility

Finally, there is the question of whether all utilities should face the same terms, or whether terms would be differentiated based on factors such as need resulting from the crisis, their financial health, and their ability to repay. Utilities will differ markedly from one another in their needs and financial positions, so one size may not fit all. At the same time negotiating unique terms with each utility would require time and a degree of judgment unlikely to be available in a crisis. It could also risk allegations of favoritism.

A useful approach may be for the financing facility to see if the utilities it serves fall naturally into different categories. These could be created by the facility or draw on preexisting categorizations. Indonesia, Kenya, and the Philippines all have grading systems in place, which already place utilities into categories. Colombia distinguishes between urban and rural utilities, based on size. Facilities

could offer terms, which are standard for all utilities in a category but differ between categories. Terms varying between categories would typically include how to calculate the amount, whether funds will be advanced as grants or loans, and if as loans, the grace period required, term, and interest rate.

In setting these terms, some governments may wish to use the approach that utilities in each category will get the amount of money that they need to keep operating. Beyond that, there will be some difficult trade-offs to be made. Financially weak utilities may have little prospect of repaying loans and so be offered grants—but this may be seen as rewarding those utilities, which may have been managed. Similarly, if financially stronger utilities are charged higher interest rates because they are better able to pay those rates than weaker utilities, the effect may again be to subsidize poor management and penalize well-performing utilities. There is no right answer to these questions. Each government will have to make decisions according to the local situation and priorities.

Notes

1. The concept of *in normal times* is used because, by assumption, the pandemic is a disruptive event that disrupts normal capital market functioning and runs the risk of making utilities that are solvent in the longer term face bankruptcy or an inability to keep functioning because of a short-term liquidity crisis.
2. This is because lenders perceive utilities as riskier than the government, so the market-based rate the facility receives is lower than the market-based rate utilities would receive.

Appendix D

Options for World Bank Group Instruments

This Appendix summarizes the different options for World Bank Group financing and the key considerations for each instrument. Depending on the needs of the client countries and the timing of the interventions in the post-COVID-19 horizon, World Bank Group support could be provided through a mixture of instruments as they are not mutually exclusive.

World Bank Instruments and related considerations

Investment Project Financing (IPF): In the current context of COVID-19 pandemic, IPFs could provide IBRD Investment loans, IDA credits and grants, and World Bank guarantees to finance the physical infrastructure and institutional capacity-building activities that would contribute to ensuring the continuity and sustainability of water and sanitation services. IPF disbursements are based on reimbursements of eligible expenditures at the component/subcomponent level. For the proposed finance facility, eligible expenditures could include: (a) predefined components of the operating and maintenance costs; (b) capital expenditures associated with the delivery and expansion of water services to the unserved communities; (c) technical assistance to shape the water sector pandemic response and recovery strategy; or (d) efficiency improvements that would contribute to lowering production or treatment cost and ensuring the continuity and sustainability of water and sanitation services during and after the COVID-19 crisis.

A Bank guarantee could be used to mobilize private financing for the water sector by mitigating payment risks. Such guarantees could cover the potential debt-service defaults, or payment defaults (in the case of guaranteed take-or-pay contracts) caused by the government or the public water service providers.

The advantages of IPF are that the proceeds can be used for the defined purpose, and that they provide the opportunity to include components that would promote policy and sector reforms, enhance the institutional capacity, and prepare for future risk mitigation measures for the water service providers. For IPFs, Performance-Based Conditions could be used to link the disbursements with specific results in enabling the implementation of needed policy and institutional changes.

The disadvantages may include the need to predefine the specific investments to fund, which can be hard under emergency situations, and the lengthy project preparation time that result from the environmental and social frameworks, fiduciary requirements, and other conditions to fulfill for project approval. This process, however, could be reduced, if (a) “projects in situations of urgent need of assistance” under Special Considerations for the World Bank’s IPF policy are applied or (b) the inclusion of the financing facility elements is considered through restructuring the ongoing World Bank supported operations. In these special circumstances, there is flexibility embedded in the policies.

Development Policy Financing (DPF): DPFs could provide IBRD loan, IDA credit/grant and guarantee budget support to governments for a program of policy and institutional actions that are taken in response to the COVID-19 crisis. DPFs are typically led by the Macroeconomic, Trade, and Investment Practice in the Equitable Growth, Finance, and Institutions Practice Group of the World Bank and help a borrower address the financing requirements associated with COVID-19 through general budget financing that is subject to the borrower's own implementation processes and systems. Bank approval and disbursement of the DPF is subject to maintenance of an adequate macroeconomic policy framework, implementation of the overall program in a manner satisfactory to World Bank, and compliance with the program's required prior actions.

The prior actions in the context of the proposed financial facility to support water service providers in crisis could include: (a) allocation of adequate public financial resources and establishment of procedures for the implementation of contingency and recovery plans for the service providers; and (b) provision of financial solutions and packages for the poor, vulnerable, and marginalized groups to have access to safe and affordable water and sanitation services at household and community levels.

The advantage of using DPFs is the emphasis on fundamental policies and reforms that are required in the sector, and faster preparation time, as a result of the use of government's own systems and mechanisms for project implementation. The disadvantages could be the difficulty for the water sector to get traction when other sectors are given priority, and the difficulty in tracking and verifying that the funds are used for the intended financing activities, because DPF disbursements go to the country's Treasury/Ministry of Finance for use against agreed policy measures. It is therefore important to include water sector specific prior actions and disbursement linked indicators to ensure that the eligible water service providers would benefit from the DPFs. Full set of possible DPF prior actions are summarized in box D.1.

Program-for-Results (PforR): PforR financing could be used to improve the continuity and sustainability of water and sanitation services by: (a) financing the expenditures of the government's program to respond to COVID-19; (b) disbursing on the basis of the achievement of key results (including prior results) under such PforR programs; (c) using and strengthening the PforR program systems to provide assurance that the funds are used appropriately and that environmental and social impacts are adequately addressed; and (d) strengthening, as appropriate, the institutional capacity necessary for such PforR programs. The programs may be new or already under implementation, and can be at the national, subnational, multisectoral, sectoral, or sub-sectoral in scope. Financing proceeds are disbursed upon the achievement of verified results specified as disbursement-linked indicators.

The advantage of PforRs is the potential fast disbursement, as it uses country systems, and World Bank could agree to disburse a portion of the PforR financing proceeds as an advance for disbursement-linked indicators that have not yet been achieved. The disadvantage is that, because the instrument uses country systems, the risk profile is higher than with other financing options especially safeguards and financial management. PforRs also have limitations for use on higher environmental and social risk operations.

BOX D.1. Examples of Potential DPF Prior Actions

Short term - water supply, sanitation, and hygiene (0 to 3 months)

- Regulations/government decrees/guidelines on preparation of contingency plans, financing, and policies to ensure the continuity of water supply and sanitation services, safety of employees, and the guarantee of the supply chain have been approved.
- Government has issued decrees to prevent the cut-off of customers for non-payment, reconnection of customers already cut-off for non-payment and put in place a fiscal transfer system to water utilities to cover the deficit.
- Regulations on treatment requirements, including disinfection for public water systems that prevent pathogens such as COVID-19 from contaminating drinking water and wastewater have been issued.

Medium term - water supply, sanitation, and hygiene (3 to 6 months)

- Government has allocated financial resources and established procedures for the implementation of contingency and recovery plans for utilities/service providers.
- Government has issued code of conduct regarding disconnections, reconnections, and payment deferrals, including plans to get the funds repaid in the future.
- Government has launched programs to support utilities in the implementation of non-revenue-water reduction programs.
- Provision of financial solutions and packages (for example, targeted subsidies) to the poor, vulnerable, and marginalized groups to have access to safe and affordable water and sanitation services at household and community levels.
- Financing mechanisms/facilities to support the local private sector/nongovernmental organizations in delivering safe water at water kiosks/water points established.

Note: DPF = Development Policy Financing.

Because the cash disbursed from PforRs are not tied fiduciary-wise to specific expenditures, including a liquidity financing element in ongoing PforR operations could be an advantage. Using the project funds for the service providers' emergency needs would not require formal project restructuring, and thereby eliminates the time and effort to prepare a new facility.

Trust Funds and Grants: Trust funds and grants (either client or Bank executed) would enable the World Bank Group to provide support when its ability to lend is limited. In the context of the proposed financial facility to support water service providers in crisis, immediate assistance could be provided in response to COVID-19, but the available funding would be limited.

Multiphase Programmatic Approach (MPA): The MPA could be used to structure a long-term water sector engagement by starting with a short-term COVID-19 response operation (or phase) and linking it with medium- to long-term reform plans under one program. This “adaptive approach” also strengthens the potential for crowding in other sources of capital to support development objectives. Projects under an MPA program may be financed by IPF, PforR financing, or both but not by DPFs.

Subsequent phases of MPA programs would be prepared as separate operations with rigorous adherence to all applicable World Bank policies including timely public disclosures and consultations with affected people. The advantage of using MPAs is that it allows learning and adaptation, as subsequent phases will be informed by the achievements and lessons from previous ones.

Key Performance Indicators (KPIs): KPIs for IPF and DPF, disbursement linked indicators for PforR, and conditions for subsequent phases in the case of MPAs could include standards for service continuity; nonrevenue water reduction; increase in collection efficiency, energy efficiency gains; meter installation or service repair schedules; the volume of waste treated or reused; or for addressing consumer complaints. These types of activities, particularly nonrevenue water reduction programs, often have good financial recovery, are labor-intensive (repairing leaks) and therefore can help get people get back to work quickly.

IFC Products

Senior loans and other debt-like instruments: IFC provides senior loans and other debt-like instruments to its clients on commercial terms to finance capital expenditures. These senior debt instruments would rank at least at the same level as other debt instruments issued by the companies (*pari-passu*). IFC finances sustainable public and private water companies through loans from its own account. In response to COVID 19 crisis, IFC could also:

- Provide loans to address short to medium-term cash flow challenges that utilities are facing because of shortfall in revenues and increased costs;
- Provide loans in local currency (available in select countries); IFC has provided debt financing in more than 60 local currencies;
- Make available partial credit guarantees for companies to be able to attract creditors;
- Set up risk-sharing facilities for commercial lenders to gain comfort in lending to companies the sector;
- Mobilize third party financing through syndicated loans, guarantees, and other instruments;
- Lend to intermediary financial institutions for on-lending to water companies; and
- Provide a loan (as Implementing Entity) on concessional terms (lower interest rate, subordination, and so on) using funds from a donor-provided facility alongside IFC’s own account loan, subject to an adequate justification for use of blended concessional finance.

Equity and mezzanine debt instruments: IFC can provide equity financing for private companies with attractive longer term growth and profitability prospects. Equity investments in public utilities can be considered when there is a plan to attract private capital and in other specific circumstances that justify IFC involvement. IFC usually owns less than 20 percent of a company and is never the largest shareholder. When needed, IFC is able to invite co-investors (equity mobilization) to participate in a transaction alongside IFC. IFC can also invest in instruments that combine characteristics of debt and loan instruments (mezzanine debt), referred to as quasi-equity or quasi-debt. These instruments can include some level of subordination (that is, not being *pari-passu* with senior debt), subject to adequate risk compensation, which can be structured as a participation in profits or other forms.

MIGA Products

MIGA Political Risk Guarantee ("PRI"): MIGA encourages foreign direct investment (FDI) in the water and wastewater sector in developing countries by providing PRI to foreign investors and lenders against the risks of currency inconvertibility and transfer restriction, expropriation, breach of contract, and war and civil disturbance. As part of its guarantee program, MIGA helps investors and governments resolve disputes that may adversely impact investments guaranteed by MIGA, thus preventing potential claim situations from escalating and keeping investments going.

IDA Private Sector Window (PSW) MIGA Guarantee Facility (MGF): There are water and wastewater projects located in IDA-FCS countries with very high country and/or project risks. As such, MIGA can deploy the PSW through the MGF to enable MIGA to extend its support to these projects through guarantees that are supported by MGF's shared first loss and MIGA's own first loss. MGF is used to mitigate the high level of risk faced by these projects and MIGA. Without use of MGF, these projects would not be possible, as investors and lenders have represented that they will not proceed without MIGA PRI cover and that guarantees are not available from the commercial insurance market or other sources. To secure support from MGF, host country needs to be eligible for IDA IFC-MIGA PSW/MGF, and the project meets all criteria for deployment of the MGF.

