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MEMORANDUM

TO: Nancy Alexander
CC: New Rules for Global Finance, Environmental Community

FROM: Financial Policy Forum:
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RE: New trends in development finance are reflected in two recent reports: one by Fitch Rating and the other known as the "Camdessus Report" or *Financing Water For All*. This memorandum provides an analytical summary of the reports in order to identify where they present possible improvements in capital markets and where they pose particular dangers to development prospects.

FITCH REPORT

The report is a potential prelude to privatization. Code name is "corporatization." Opposition to privatization is claimed to be "a general public backlash against privatization." FITCH has not made the case for why privatization is inherently better. They have made the case for why attracting private investment can be helpful.

FITCH report VERY badly written due to incompetence and a lame attempt to spin the issue. It is disorganized, full of jargon and buzz words, and rambles along until it arrives (actually it just stops) at a "conclusion" that was not even hinted at in the introduction. Hardly a top rate intellectual product from a top rated, wealthy organization. This does not mean that the report is not important.

What is the underlying significance of the FITCH report?

First, it makes the obvious point that in order to attract more foreign private capital the developing country infrastructure projects much make the investments less risky. This should be accomplished by backing up the projects with a reliable source of revenue. Sources of revenue in local (subnational) governments include: revenue sharing transfers from central government, local taxes, payments for local services and payments on services from prospective and existing infrastructure projects.

Credit enhancements include the use of "covenants" or contracts to specify from the beginning the rules under which reserves will be held to assure debt service payments, project revenues (taxes and user fees) will be used to make debt service payments and replenish reserves.

Part of report is designed to address the risk to developing countries from the private entity defaulting or going bankrupt. One such method is to set up a SPE to serve as a "Bankruptcy Remote Entity." It acts as a trust to own the asset and receive revenue and make payments on debt service.

Implications of the substance of the report

- The major thrust is to improve, through the potential use of various credit enhancements, the supply of foreign private capital to infrastructure projects in developing countries.
- Also a serious warning to private investors of the benefits of SPE used to structure financing.
- Also contains strong recommendation to clarify any government guarantees and indicates which type is most valuable for foreign investors.

Suggestions for improving investment conditions:

- legal
- social – public acceptance of paying directly or indirectly for services
- intergovernmental (intranational) – formalizing the relationship between central and local governments
- collateralization – arranging for private investors to hold senior claims on revenues from taxes or fees for services

"Concluding" section

This section describes the structure of new financing methods. This memo has an attachment that attempts to represent this structure in a diagram. The basic idea is the improve the credit rating of developing country infrastructure projects, and thereby lower the cost of capital, by structuring the finance in a way that reduces the likelihood of default or bankruptcy.

The basic trick is to form a special purpose entity (SPE) to act as a trust. The SPE will issue debt to foreign investors and then loan the funds to finance the project. The interest rate will be reduced because of credit enhancements. These credit enhancement include: guarantees from IFIs, guarantees from the central government, reserves held in the trust for making payments in the short-term (sort of a Brady Bond type of arrangement or a RRG type of arrangement used by the World Bank), senior claims on transfers from central to the local government, senior claims on local taxes raised by the local government and claims on all user fees charged for service provided by the project.

Once the project provides services, the associated fees and taxes will be transferred to the SPE and will be used first to repay foreign investors. Remainder will be used to pay a return to the project. This return will be profit for private owned project, and it will become revenue for a public owned project.

Note that this financing mechanism can be for either private or public ownership. In fact it is taken from an example in the U.S. where local water projects are financed through a similar structure. The fact that the SPE creates a "corporatization" of the project does make it easier to privatize.

Critical Commentary:

Issues needs to be looked at with a level-headed, analytical eye and not driven by laissez-faire ideology. This means that the potential benefits from private sector involvement should not be assumed but rather elaborated and supported with the best possible evidence. Similarly, the potential benefits from public ownership should not be treated as negative by assumption but instead should receive a fair analysis and assessment. Towards this end, it should be kept in mind that the potential relative benefits of public ownership might not be limited to economies within the "firm" or entity providing the services. Public entities sometimes provide benefits to the overall economy that cannot be fully captured or internalized by such entities, and these benefits would not likely be produced by a private entity. Consider the following list of examples:

Social and economic benefits of public owned service providers:

- non-cyclical employment and compensation (stabilizing force in macroeconomy)
- non-discriminatory hiring (more willing to hire disabled, women and minorities)
- implicit welfare, social safety net, transfers (price incentives may not be efficient for people with incomes below a critical level)

Benefits of privatization that should not be assumed:

- efficiency gains (just by judging from the quality of the Fitch report we can see that the private sector can produce very low quality output)
- greater investment in innovation
- private entity might become bankrupt or might default on contract

CAMDESSUS REPORT

The "Camdessus" report reveals the large changes that need to be made in the water infrastructure to arrive at the Millennium Development Goals. The paper calls for a doubling of financial flows to water projects. Although Camdessus calls for a doubling of official development assistance, the major focus is on attracting private flows. Water is not seen large private investment because of the high fixed costs, long payback period, inefficiency and low rates of return. Camdessus suggests this can be changed through guarantees, training, and decentralization but most importantly through higher tariffs on water. He believes there exists an appropriate tariff structure that can ensure individual affordability of water. A stepped up structure will charge higher rates to higher quantities but this as the author mentions penalizes large families. The structure will likely result in small scale water providers buying water in large quantities before breaks occur in the structure and then reselling the water at different blocks to take advantage of the stepped up structure. The system then provides a benefit to small water providers while taking away value from users of water.

Foreign exchange risk is seen as the largest obstacle in attracting external private capital. Camdessus comes up with two solutions to reduce forex risk. The first one increases water tariffs based on some formula that takes into account the magnitude of the devaluation. Even the author recognizes the fact that this could lead to unrealistic tariff increases. The second solution sets up a credit facility in a multilateral financial institution. The facility will hand out loans to foreign lenders equivalent to the amount that interest payments exceeds the repayment capacity of the water project. These loans are guaranteed by the host government which pays back the loan through surcharges on water. In the appendix is the hypothetical situation where a 50% devaluation would only lead to annual increase of 1.4% in water tariffs. This example assumes foreign debt service is only 17% of revenues and the service provider can remain profitable. What about worse case scenarios: devaluations of 75% or more, higher ratios of foreign debt service and the bankruptcy of several service providers. Since the loans are government guaranteed, higher surcharges will have to be placed on the surviving water service providers. This could lead to much higher annual surcharges than the 1-3% that is being predicted. Foreign exchange risk should be held by the private investors. These investors have the sophistication and access to transfer and transform the foreign exchange risk while local water service providers don't. The foreign exchange swap market presents an effective manner to reduce foreign exchange risk thus it should not be a large obstacle in attracting capital.

The major assumption by Camdessus is that the poor can and are willing to pay extra for water. He even cites that the poor can pay up to 5% of their income for water. In reality, the poor will pay whatever they have to in order to get water. As a requirement for survival, water has a near infinite inelasticity. The author makes the argument that higher prices will lead to better service, expansion of service, attract more funds and will also free up public funds for other uses. It almost sounds like he is making the argument that pain and suffering today will lead to a better future.

More attention should be placed on improving the technological and managerial capacity of water providers. The paper mentions donor assistance in these areas but does not mention the resulting efficiency gains or cost savings. These cost savings might be able to bring costs under the current tariffs and would prevent the need for any increases.