

# Roundtable on Financing Water

## The Roundtable on Financing Water

Third meeting, 12 November 2018, Paris

### Discussion Highlights

The third meeting of the Roundtable on Financing Water gathered over 90 participants including private investors and financiers, development finance institutions, government officials, philanthropies, NGOs and research institutions. The meeting focused on recent developments and new analytical work across three main themes: mapping financing flows; blending finance for water investments, and strategic investment pathways.

A brief summary of the highlights that emerged from the discussion is provided below. The agenda and background papers are available on the meeting [webpage](#).

#### Key messages

##### ***Setting the scene***

- Water resources are an essential component of natural capital and an important factor for all three dimensions of Environmental, Social and Governance (ESG) criteria, which are gaining growing attention from investors. However, water resources and services remain greatly undervalued and under-priced.
- Water-related investments could be made more attractive for institutional investors through: (1) integration with other projects, such as urban development, (2) developing long-term projects to allow investors to reap benefits from on-going operations, (3) improving scalability; intermediaries have a decisive role to play, which needs to be better understood, (4) establishing more cost-reflective water prices, and (5) improving the regulatory framework to attract private capital.
- Of the over USD 500 billion of cumulative issuance in the green bond market, estimates suggest that USD 170 billion of issuance is eligible for water-related investments.<sup>1</sup> Recent developments in the nascent Sustainability and Social bond market show potential for growth.

##### ***Blended finance for water and sanitation***

- To scale up the effective use of blended finance for water and sanitation investments, the focus should be on promoting local currency financing and the development of local capital markets. While there is agreement on the need for improved co-ordination among development finance providers, actions on the ground remain fragmented, which can stall efforts to attract commercial capital into the sector.
- A CAPEX-driven investment approach can bias decisions, for example by downplaying the importance of securing long-term financing for OPEX and neglecting lower costs options for the delivery of services, such as non-sewered sanitation. Funding models need to reinforce accountability for the delivery of sustainable services, not just the disbursement of funding. Small investments focussed on utility performance and

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<sup>1</sup> According to SEB [analysis](#).

# Roundtable on Financing Water

operational efficiency are vital to improve utilities' balance sheets and help turn utilities into creditworthy borrowers with access to commercial finance.

## ***Mapping investment needs and financing flows***

- Estimating investment needs and financing capacities at country level is an important building block to guide strategic thinking about countries' investment planning and financing strategies.
- Water risks are increasingly recognised as a material factor for credit ratings of corporates. For financiers, greater awareness of the link between climate risks and water risks is needed, including to implement the recommendations of the Task Force on Climate-related Financial Disclosure.
- On the opportunity side, commercial banks are developing innovative lending products designed to provide incentives for reduced water impact and asset managers are developing strategies to capture the potential for attractive risk-adjusted returns from water investments.
- Innovation in terms of business models and technology can strengthen the financing fundamentals for water investments. The digitisation of the water sector can help secure revenue streams, improve asset management, reduce transaction costs for financing and provide more robust data relevant for investors.

## ***Strategic investment pathways***

- Nature-based solutions have significant potential to lower the costs of achieving water security and related co-benefits (e.g. for biodiversity, etc.). Impact investors and NGOs are actively working to scale up these solutions. Science-based metrics are required to better integrate natural capital into investments and to ensure that they deliver economic and environmental benefits.

## **Setting the scene: Recent developments related to financing water**

To set the scene, keynote speeches outlining recent developments related to financing water were delivered from the perspectives of both policymakers and investors. Ms. Joanna Drake, Deputy Director-General, DG Environment, European Commission, highlighted key developments for water in the context of the EU's Action Plan on Sustainable Finance. The Action Plan aims to integrate sustainability into the EU's financial policy framework to boost the mobilisation of finance for sustainable growth. These efforts include the development of the EU taxonomy for environmentally sustainable investment activities, which will form the basis for developing green bonds standards. The Action Plan also aims to support asset managers, pension funds and insurance companies to integrate ESG factors into their investments and improve transparency. Water resources are an essential component of the EU's natural capital and an important factor for all three dimensions of ESG, but remain greatly undervalued and under-priced.

In the EU, although water-related investments have been a significant beneficiary of the EUR 16.8 billion spent via Cohesion Funds on environmental protection, there is still a gap in many member states to reach full compliance with the water *acquis*. Current efforts focus on how to increase funding for water-related investments, while maintaining affordability, better applying the polluter pays principle and looking for cost effective options, such as nature-based solutions.

[Mr. Peter Damgaard Jensen](#), CEO of PKA (Denmark's 4<sup>th</sup> largest pension fund) and Chair of the Institutional Investors Group on Climate Change provided an institutional investor's perspective on water. PKA's commitment to green finance reflects its members' genuine interest in the ESG agenda and is fully aligned with its fiduciary duties. Institutional investors can pursue several channels of influence in their approach to green finance, including direct engagement with companies on ESG issues (including highlighting the potential for stranded assets), excluding

# Roundtable on Financing Water

companies from their investments for environmental reasons, actively investing in green investments, encouraging public policies to support green finance.

Water-related investments can be made more attractive for institutional investors by: (1) integrating water-related investments with other projects, such as combining flood protection with urban development, (2) developing long-term projects allowing investors to reap benefits from on-going operations is more attractive than one-off investments, (3) improving scalability, (4) establishing more cost-reflective prices, and (5) improving the regulatory framework to attract private capital. Experience from climate-related investments highlights the importance of designing the business model to attract private investment from the start.

[Dr. Christopher Kaminker](#), Senior Advisor and Head of Research, Climate and Sustainable Finance at SEB provided an update on water finance with a focus on the debt capital markets. A decade of experience with green bonds illustrates how linking the SDGs on water and oceans to debt capital markets could facilitate tapping into USD 100 trillion of capital managed by global institutional fixed-income investors. For investors, green bond markets offer stable, rated and liquid investments with long duration.

According to SEB [analysis](#), the green bond market has seen USD 525 billion in cumulative issuance over the past decade. Over USD 170 billion of issuance includes water as a potential use of proceeds. In 2018, the green bond market is expected to consolidate, rather than continuing the exponential growth seen in previous years. Examples of water-related issuance include the Dutch NWB Bank, Fannie Mae (refinancing real estate investments with lower water impacts), and the European Investment Bank's (EIB) inaugural Sustainability Bond with its focus on high-impact water investments. Recent S&P analysis reviewing rating actions over the past two years found that 169 ratings where water risks were a material factor in the analysis and 28 instances where these led directly to a rating action.

## Session 1. Blended finance for water-related investments<sup>2</sup>

Water-related investments have traditionally been financed by the public sector, with concessional donor finance playing an important role in developing countries. According to OECD [analysis](#), official development finance flows to water and sanitation were USD 12.5 billion on average in 2015-16. This represents only a fraction of the estimated investment required to meet the water-related SDGs. At the same time, developing country governments are fiscally constrained, and private financing flows for water investments have been limited to date.

Blended finance, defined as the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries, offers a promising approach to harnessing additional resources for water. For example, Water.org has demonstrated that blended finance can catalyse the marketplace for microloans and recently surpassed USD 1 billion in private finance mobilised. However, while blended finance is gaining traction in many sectors, overall, developments remain modest when it comes to water-related investment.

To further scale up the use of blended finance for water<sup>3</sup>, the focus should be on promoting local currency financing and the development of local capital markets. The use of blended finance can generate a positive self-reinforcing cycle by strengthening financial discipline of water utilities and their creditworthiness. Recognising the significant inefficiencies in the water sector in many countries, efforts to mobilise additional sources of finance must be accompanied by reinforced efforts to maximise the effective use of existing sources of finance. Strengthening utility management as well as the broader enabling environment (e.g. the policy framework and institutional arrangements) is vital.

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<sup>2</sup> This session builds on the outcomes of the recent GIZ-OECD Conference Closing the Financing Gap for Water in Line with SDG Ambitions: The Role of Blended Finance. Further details on the key messages from the conference can be found in the [conference outcomes](#)

# Roundtable on Financing Water

One of the persistent gaps in financing for water and sanitation relates to non-sewered sanitation. In the area of urban sanitation, large investments in massive, centralised infrastructure dominate, with investments in off-grid, small-scale sanitation often left to private actors. These large infrastructure investments are very costly, but may only deliver marginal improvements in access for users and may increase the utility's financial vulnerability, especially where investments in maintenance remain insufficient. Support from governments and development financiers can encourage a more integrated and pro-poor approach to water and sanitation service provision. The Bill & Melinda Gates Foundation, for example, is supporting comprehensive city-wide planning for pro-poor sanitation services with both sewerred and non-sewerred investments. Greater use of blended finance could help to de-risk sanitation investments and unlock commercial lending. The "Reinventing the Toilet" initiative pioneered by the Gates Foundation could be a game-changer for access to sanitation, especially for the poorest households.

The role of intermediaries, such as the Water Finance Facility (WFF) (an initiative of the Government of the Netherlands) is fundamental to bridge the supply of and demand for long-term debt financing. The WFF aims to mobilise local currency capital from domestic institutional investors. Long tenor debt financing is better suited to investments in long-lived infrastructure needed for water services. To reach an attractive scale for investment, projects from several water service providers can be pooled.

The lack of creditworthiness of water service providers (WSPs) and the perception of corruption and poor governance in some countries can deter the engagement of private finance. Funding models need to reinforce accountability for the delivery of service outcomes, not just the disbursement of funding on project-by-project basis. Results-based models can help focus all stakeholders' attention on performance outcomes.

Investment in the water sector tends to focus strongly on large-scale CAPEX, while small investments in capacity building and technical assistance that improve the long-term efficiency of utility operations are often overlooked. However, large loans for CAPEX can actually reduce utilities' creditworthiness. Capacity building needs to be much more closely integrated in investment design. The Dutch development financing institution, FMO, has recently begun looking at water-related investments launching a programme to improve the health of utility balance sheets. These involve very small (EUR 1-5 million) investments focussed on utility performance and operational efficiency. These small investments are vital to shoring up utilities' balance sheets. However, it is difficult to find financiers in this market, as commercial banks prefer larger ticket items.

Development financiers should seek to crowd-in private financiers and avoid undermining incentives for creditworthy borrowers to access commercial finance. Competition among lenders can lead WSPs to wait for concessional financing, rather than accessing commercial finance. However, concessional finance can be more expensive over the lifetime of the loan when taking into account the impact of foreign exchange fluctuations on total borrowing costs.<sup>4</sup> While there is agreement on the need for improved co-ordination, actions on the ground remain fragmented, which can stall efforts to attract commercial capital into the sector. In the Philippines, the government issued an executive order instructing creditworthy utilities to make use of commercial finance (and not rely on concession finance from donors).

The European Investment Bank (EIB) recently issued its first Sustainability Awareness Bond (SABs) of EUR 500 million, with the focus on high-impact water projects. Eligible investments include access to water, leakage reductions in networks, etc. Initially, SABs will focus on investment in water supply, sanitation and flood protection, with the expectation to expand to other sectors, such as health and education. In terms of blended approaches, this is typically done through guarantees from the European Commission.

There is a role for innovation and technology to strengthen financing for water-related investments. Digitalisation can help to reduce the transaction costs associated with blended finance and translate scientific data into terms that

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<sup>4</sup> This is illustrated in a conceptual comparative analysis of lending parameters on borrowing costs in [Goksu et al. \(2017\)](#) "Easing the Transition to Commercial Finance for Sustainable Water and Sanitation" (see Appendix B).

# Roundtable on Financing Water

make sense for financiers. Mobile payments can help secure utilities' revenue streams, allowing utilities to generate a cash surplus to start improving efficiency of operations. One example is CityTaps, which uses a pay-as-you-go solution with mobile payments.

## Session 2. Mapping financing flows: Estimating investment needs and financing capacities

A substantial financing gap for water-related investments globally is widely acknowledged. Lack of data and information about investment needs and comparable indicators of financing capacities at country level impede the effective and efficient allocation of resources for water investments. Estimating investment needs and financing capacities at country level is an important building block to guide strategic thinking about countries' investment planning and financing strategies. Further, data that are comparable at a regional or global level can help to inform decisions of actors allocating resources across multiple countries as well as promote cross-country co-operation and learning.

The ongoing [OECD-EC study](#) of the investment needs and financing capacities for water supply, sanitation and flood protection in the 28 EU member states aims to raise awareness about the financing challenge and ensure that investments in the water sector are channelled to where they generate the most benefit for society. There are currently large differences among member states in terms of their compliance with the EU water *acquis* and significant implementation gaps remain in some countries. At the same time, new challenges need to be taken into account, such as climate change and contaminants of emerging concern (CECs).

In the analysis for EU member states, the main drivers for projected investment needs in water supply and sanitation are urban population growth, distance to compliance with the relevant EU legislation, access to services, efficiency and emerging issues, such as CECs. For flood protection, the main drivers of investment needs include population, economic growth and climate change as well as the increase in the value of assets at risk. Financing capacities are constrained in many countries, with affordability constraints limiting room for manoeuvre to increase tariffs for lower income households. However, even when financing is available, absorptive capacity can limit investments. The analysis of EU countries could potentially be replicated in other regions, to improve the evidence base to better understanding the financing challenges for water-related investments.

The Union for the Mediterranean's (UfM) Task Force on Financing is developing a financing strategy, examining the financing needs and options for the region. Data on financing needs are scant for countries in the lower Mediterranean region, in particular, and analysis to map financing needs and capacities would be useful. There is a recognition that the financing strategy needs to focus on the mobilisation of additional sources of funding, but also increased efficiency of operators, asset management, and optimising the use of existing sources of funding.

From the commercial bank perspective, water risk is also a credit risk, with more downgrades than upgrades providing a motivation for commercial banks to engage in better understanding these risks. There are also opportunities for financing, for example through lending products designed to provide incentives for reduced water impact. Banks are increasingly aware of climate change issues, but often the link to water risks is missing. For financiers, greater awareness of the link between climate risks and water risks is needed, including to implement the recommendations of the Task Force on Climate-related Financial Disclosure. Strengthening this link can also underscore the consequences of failure to address climate change risks.

For asset managers, the risk-return profile of water investments would be more attractive if policymakers adopted more robust and consistent tariffs and expanded the regulated asset base for utilities. Tariff structures can be designed to address differentiated ability to pay and be more transparent.

# Roundtable on Financing Water

## Session 3. Strategic investment pathways

Water-related investments can generate substantial benefits from a social welfare perspective. Government authorities, development finance institutions and project developers would benefit from situating project pipelines within broader investment pathways, which sequence projects in a way that maximises benefits for communities.<sup>5</sup> Strategic investment pathways should also be designed with a basin-wide perspective that recognises the positive or negative externalities that investments can have on other users of a shared resource, and the benefits generated by a combination of investments that are mutually reinforcing. Better reflecting the value of water and the natural capital that supports water security can enable more cost-effective and resilient infrastructure investment decisions.

The water sector provides ample opportunities for delivering positive social outcomes. Danone Communities provides an example of a mutual fund invested in social business. The fund aims for capital preservation and high impact to improve access to safe water supply for low-income households (<5 dollars/ day). The fund works with social entrepreneurs experimenting with new business models for water kiosks. While there is a huge potential market, providers are facing increasing competition. Well-designed regulation can help develop the market.

Payment for ecosystem services can provide a structure to channel funding for water catchment protection. The Nature Conservancy (TNC) has considerable experience, developing more than 30 such water funds since 2000. Recent analysis by TNC suggests that nature-based solutions can improve the quality of water sources serving over 700 million people living in the 100 largest cities and reduce drinking water treatment costs (in addition to delivering a number of other co-benefits).<sup>6</sup> TNC also has an impact finance unit, NatureVest, which functions as an intermediary to engage private capital to scale conservation.

For the impact investors Althelia, natural capital is still a very small part of the investment portfolio. Water is closely integrated into investments related to agriculture. Many of these investments require a grant element and/ or first loss capital. Investment has been mainly focussed on Latin America and Africa to date. Investment in Europe is of interest, but structured funds with a public element may be considered State aid under EU rules.

Scaling up the use nature-based solutions will require overcoming some well-known barriers. For example, making the shift to NBS for drinking water provision requires time to transition and public finance is often delayed until the outcome is achieved. Despite the enthusiasm for the green bond market and growing interest in ESG from investors, without the obligation to reliably measure impact, positive environmental outcomes may be limited. Robust science-based metrics are required in order to more systematically integrate natural capital into investment decisions. The World Resources Institute (WRI), for example, has been further developing decision-relevant tools (e.g. Aquaduct and Resource Watch) to better understand and analyse water-related risks.

For more information, please visit:

<http://www.oecd.org/water/roundtable-on-financing-water.htm>

[www.oecd.org/water](http://www.oecd.org/water)

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<sup>5</sup> See: OECD (2018), "[Emerging good practice in project pipeline development](#)", *Developing Robust Project Pipelines for Low-Carbon Infrastructure*.

<sup>6</sup> The Nature Conservancy (2018), [Urban Water Blueprint](#).