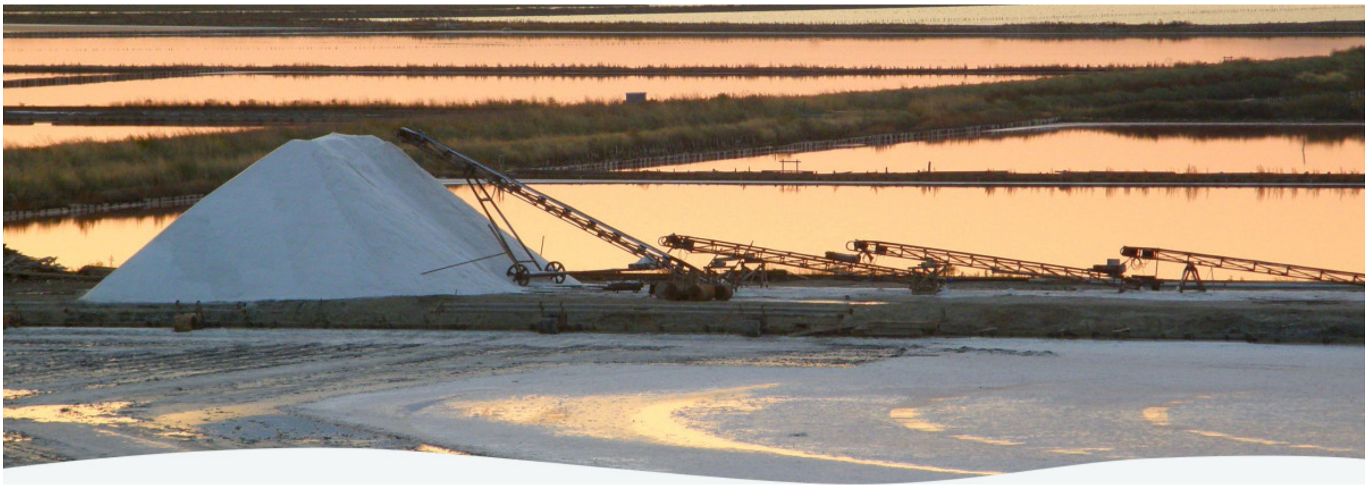
IWRM Action Hub

IWRM TOOL - D2.05

Blended Finance



Summary

Blended finance is a structuring approach that allows for the mobilisation of commercial/private capital by using concessional or philanthropic funds as de-risking mechanism. Blended financing can thus act as catalyst in attracting private investment in areas where the cost of capital and the risks are too high and investment track records are poor. This Tool provides an overview of the key characteristics of blended finance, its five principles, and how it could be potentially further applied to cover the funding gap in the water sector.

What is Blended Finance?

There exists a funding gap in order to achieve set SDGs by 2030 especially in developing countries, which have limited development capital and also struggle to attract private investment. One of the solutions to mobilise this private capital is through blended finance. Blended finance is a structuring approach that involves utilising concessional capital, mostly public or philanthropic, to attract or "crowd-in" private investment towards implementing projects in developing countries and in achieving sustainable development.

Concessional capital/funds are flexible in absorbing risk or often have no objectives of getting a market-comparable or even lower returns. Thus, they are used or "leveraged" to drive the cost of project down or reduce risks for private investors. The concessional capital can come from the Government, Multi-lateral Development Banks (MDBs), Official Development Assistance (ODA), Grants from Foundations, etc. Using these as catalysts to draw in private investment by covering transactional and regulatory risks is the essence of blended finance. This leveraging of private investments can help in realising socio-economic and environmental goals of public partners while, also generating returns for the private investors thus, maximising the impact of a development scheme/program.

Blended finance targets projects that have a clearly defined revenue stream (bankable) or projects that have slightly lower returns but still have very high development impact (semi-bankable). Non-bankable projects are not the target of blended finance because the probability of failure or financial loss is too high. Four of the most used blended finance mechanisms are (see Figure 1):

- Co-investment of concessional and private funds. The concessional capital drives the overall cost of capital down or serve to provide an additional layer of protection to private investors.
- Guarantees and insurance by philanthropic investors although these credit enhancements are not often below market terms.
- Grants for technical assistance either at the start of the project or after the completion to measure impact.
- Grants for design or preparation of the transaction structure.

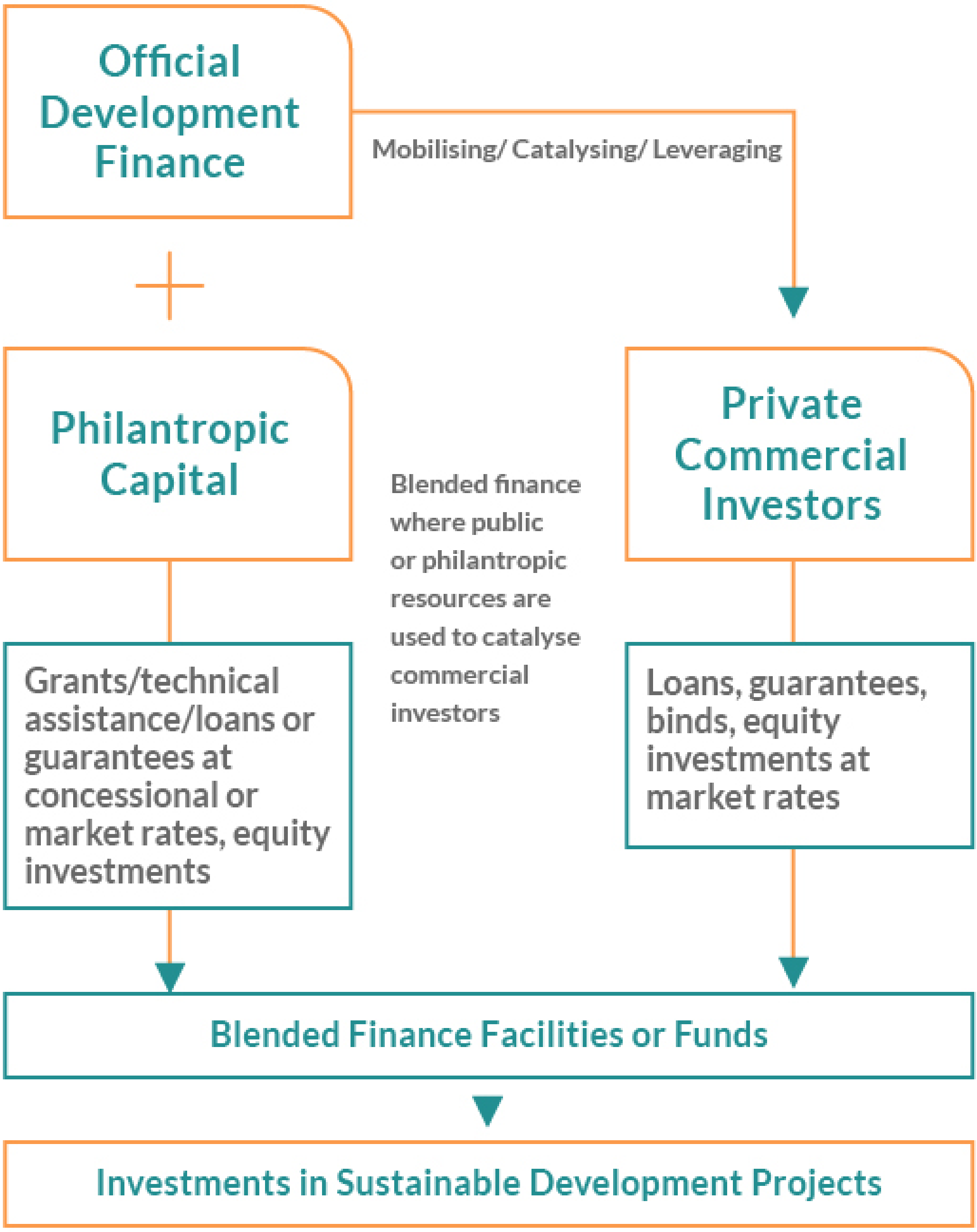


Figure 1. Blended Finance Mechanisms (Adapted from Tan, 2019).

Principles of Blended Finance

The OECD Development Assistance Committee (DAC) has defined blended finance and delineated five principles, which are globally recognised as standard practice (OECD, 2021). These principles enable organisations to understand what blended finance is and how they can utilise it for sustainable development. The five principles are:

- Anchoring blended finance within the development rationale of socio-economic and/or environmental improvement within developing countries in line with donor's development mandate.
- The public capital should ensure additionality for mobilising private investment with an aim to achieve the set development outcomes.
- Donor should ensure that the blended finance fits the local development needs and capacities while contributing to local financial market development.
- Donor and private partners should have complementary characteristics towards risk sharing, both development and commercial to keep motivations intact, ensuring quality and achievement of set targets.
- Blended finance should have transparency and accountability between donors and private partners to maximise effectiveness of the intervention in fulfilling goals of the donor as well as the private partners.
- The OECD-DAC has developed a guideline including definitions, challenges, best practices and checklists to make implementation of blended finance easy for organisations (OECD, 2020). Furthermore, for diving even deeper, each principle has its own detailed guidance note for specific instructions.

Blended Finance in Water Sector

A blended finance initiative must offer returns comparable with market, cover regulatory and financial risks and have a clear long lasting revenue stream (OECD, 2019). Attracting private investors is easier in the developed and middle-income countries because they have a clean and stable investment track record and low perceived risk. Whereas, in the developing countries where there is acute shortage of funds and need private investments, the instability and fragility of the market, politics, and security result in high perceived risks and an investment record that is absent.
Ikeda et al. (2020) have identified that the water sector adds more obstacles in attracting private investment such as:

- Infrastructure projects requiring high amounts of capital and spanning over very long durations before generating any cash flows. Even after becoming operational, the low tariffs within water and sanitation projects cannot fully recover cost of the asset.
- Heavily fragmented responsibilities with regards to water resources with multiple actors in play making it difficult to get everybody onboard. In some countries, the regulatory frameworks discourage private partnerships within water sector.
- Project planning within the water sector is often poorly designed due to plethora of contributing factors such as local context – both, cultural and climatic, types of infrastructure and technologies, etc.
- The water sector can broadly be categorised into "Water and Sanitation Utilities", "Off-grid

Sanitation”, “Multipurpose Water Infrastructure” and “Landscape based Approaches”. Amongst these 4, the utilisation of blended finance is at different stages (OECD, 2019). Their report found that blended models are easier to implement in projects belonging to Water and Sanitation Utilities and Multipurpose Water Infrastructure due to their ability to offer clear revenue streams and the potential of full cost recovery. This translates to a healthy transitory trend towards lesser concessional capital needed to crowd-in a lot more of commercial funds. However, for projects belonging to Off-grid Sanitation, the remote schemes with mostly an uplift objective tend to offer measly profit margins while the perceived and actual risk of project success remains significantly high. This is depicted in the form of grant-based blended models being used for such schemes which mostly cover the risk in order to lower the cost of the capital.

Thematic Tagging
Private Sector
