

ENHANCING THE CREDIT OF OUTPUT-BASED AID PAYMENTS

Before committing funds to a project, commercial providers of project finance carefully assess the riskiness of the cash flows from which their loans will be repaid. For an infrastructure project supported by output-based aid, the cash flows are of two types: tariff payments by customers and subsidy payments by a government or government entity (such as a public utility). Each of these cash flows has different characteristics and so implies different risks. Project finance providers will look at the combined risk.

In many countries government payments are considered unreliable and so are assigned a low credit rating by financial markets and investors. In these cases the quality of OBA payments needs to be enhanced—that is, lifted to a higher level—if they are to become a creditworthy part of a project's cash flow. World Bank guarantees offer one way to structure OBA payments that can help attract market financing for infrastructure projects. The two main options are partial risk guarantees and partial credit guarantees.

Partial Risk Guarantees

The World Bank's partial risk guarantees can backstop government OBA payments. That is, they can provide a guarantee against government default on OBA payments (up to a pre-agreed amount) to a private infrastructure provider. If the government does default, a commercial bank takes over the payments, under a letter of credit to the infrastructure provider, backed by the World Bank's guarantee. The World Bank then reimburses the commercial bank under a counter-guarantee by the government.

A partial risk guarantee could be used for transition (declining) subsidies as well as for long-term subsidies. It could also be combined with an International Bank for

Reconstruction and Development (IBRD) loan or International Development Association (IDA) credit, with the loan or credit financing government payments during the initial period (say, for the first 5–6 years) and the guarantee taking effect thereafter (say, for the next 10–15 years).

Partial Credit Guarantees

Partial credit guarantees cover private lenders against all risks during a specified period or for a specified share of the debt. These guarantees, available only for countries that borrow from IBRD, are designed to extend and improve market terms for borrowing by public entities. They are poorly suited for backstopping OBA payments to a single project, since governments are unlikely to add to their commercial debt simply to finance subsidies. But they could be used to capitalize a subsidy pool set up to finance OBA payments for several (or many) smaller projects—a structure that could reduce transaction costs for each project as well as total financing costs. This facility could initially be financed through IBRD loans or IDA credits, other external aid funds, and the government's own resources. For its contribution, the government could use a partial credit guarantee to obtain more favorable borrowing terms. To ensure sustainability, the initial contributions could later be supplemented and eventually replaced by sector levies and user charges from existing operations or by other revenue sources, including taxes.

For more information on Credit Enhanced OBA's, please contact Stephan von Klaudy at svonklaudy@worldbank.org.

Read more: Credit Enhanced OBA Working Paper