MINISTRY OF FOREIGN AFFAIRS
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Mykolaiv
city on the wave

Assistance to the Development of the Mykolaiv Masterplan

Financing Options for Municipal Infrastructure

Final

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COWI

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List of Abbreviations

ADB	Asian Development Bank
AIIB	Asian Infrastructure Investment Bank
CAF	Development Bank for Latin America and Caribbean
CEE	Central and Eastern Europe
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EIFO	Export and Investment Fund of Denmark
ESSF	Mykolaiv city administration
EU	European Union
EUR	Euro
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDB	International Development Bank
IFC	International Finance Corporation
IFI	International Financial Institution
IPO	Initial Public Offering
MCA	Mykolaiv City Administration
NIB	Nordic Investment Bank
PIP	Priority Investment Programme
PPP	Public Private Partnerships
SPV	Special Purpose Vehicle

1 Introduction

The needs for reconstruction of Ukraine are enormous. So is the financing required. Mykolaiv City is no exception. Alone the capital investments required in Mykolaiv City within water, energy and waste sectors amount to more than 3 billion EUR. It follows from the Priority Investment Programmes prepared by COWI in connection with the development of the masterplan for the city.

Hence, the question: How to finance these capital investments and subsequent operational costs? Taxes, tariffs and transfers (in terms of official development assistance or grants) can not make it alone. Not in the short to mid-term. Other financing mechanisms have to be introduced.

This document has been prepared with the overall purpose to launch a discussion about such other financing mechanisms. It provides and overview of possible financing mechanisms and ways to arrange them. Such an overview will be useful for management of municipal companies operating in Mykolaiv, because it will provide listing of available financial instruments in general, and point to the instruments that are relevant for municipal companies in Mykolaiv in particular.

Hopefully, the document may facilitate fund raising and coordination among IFIs, donors and other investors, as well as government bodies, committed to the development of Mykolaiv City.

The document consists of three chapters in addition to this introduction: Chapter 2 provides an overview of possible financing instruments, Chapter 2 addresses the possible organizational setup, and Chapter 4 puts forward a few recommendations on next steps. Two annexes are attached to the document. One providing a few references, another introducing Special Purpose Vehicle.

A draft version of the document was shared and discussed with Kåre Stamer Andreasen, Finance Director / Counsellor, EIFO - Embassy of Denmark to Ukraine, and Peter V. Helk, Senior Consultant, Danish Industry. Questions raised at the meeting were, among others: How to leverage existing financing sources? Which are and which will be the requirements to local conditions if the needed financing is to be attracted? What guarantees will the financers look for?

However, the final version of the document is solely COWI's responsibility.

2 Possible instruments, Brief overview

Municipal sector (water, district heating and waste) are being financed by tariffs, taxes and transfers (from abroad). These are the primary sources of financing for this sector, they are non-repayable, and they are subject to regulation by local and national legislation.

All other sources of financing are external, in the sense that they are repayable with some percentage or rate of return. These include:

- Loans
- Grants
- Bonds
- Shares (equity).

Apart from this, Guarantees are frequently used as enabling environment for loans. So that, we will also consider what type of guarantees exist and which organizations issue them.

2.1 Loans

In its pure definition the loan is a credit instrument via which a certain amount of money is lent to another party in exchange for agreed future repayments. Typically, the future repayments include interest charge in addition to the principal amount. Loans could be advanced by financial institutions (banks), municipalities (municipal loans), governments (government loan), or even by individuals.

When advancing a loan, a lender will typically consider future financial position of the borrower. These can include many parameters depending on the purpose, but will always include potential income of the borrower, his credit history, and if available, his credit rating. Lenders decide, based on these parameters, whether to lend money to the borrower or not, and if decision is positive, which interest rate to charge. Typically, lenders charge higher interest to more risky borrowers.

Loans can have many features, but the most important are unsecured or collateralised, revolving or term, guaranteed or non-guaranteed. If the loan is collateralised, that means that the borrower provided some form of tangible guarantee (collateral) against future payments. The collateral usually is an asset that belongs to borrower. If the loan has specific and finite payment schedule it considered as “term” loan. If, however, the repaid amount can be invested again, it is called a “revolving” loan. Finally, if a borrower provides an external commitment against a loan, then the loan is “guaranteed”. In such cases, the guarantee provider commits to repay full or partial amount of loan in case the borrower cannot meet the payments. Otherwise, the loan is considered non-guaranteed. Guarantee is usually provided by specific agencies against certain fee.

Specifically, for municipal companies it is important to know that there are following types of loans:

- Working capital loans, which are usually provided by commercial banks and have short terms. This type of financing is used to close the gaps between money outgoing (costs) and money incoming (tariffs and other payments) in a regular operating process of the company. Especially for municipal companies in CEE countries, when new tariffs are approved with delays, this is important instrument in keeping day-to-day operation smooth. Many companies even have so called “credit lines” agreed with banks, when they can draw on readily-available funds as needed within the year.

- For a large-scale investment into municipal infrastructure commercial bank loans are also available. But the screening process for these purposes are very tough, bank usually require an external guarantee, and terms of such loans are usually very short. It typically does not match the expected earnings profile, and, therefore, can be used as temporary step in arranging more long-term financing.

- In CEE countries, loans from IFIs (it is more correct to say Multilateral Banks established by IFIs) are a better option and they are available subject to certain conditions. Such loans are better placed for municipal sector, because they are long-term and match the cashflow profile of project. Loans with such characteristics are usually advanced by:

  - EBRD – European Bank for Reconstruction and Development
  - World Bank and its branches, such as IFC (International Finance Corporation) and IDB (international Development Bank)
  - European Union and its investment bank EIB (European Investment Bank)
  - NIB – Nordic Investment Bank
  - ADB - Asian Development Bank
  - AIIB – Asian Infrastructure Investment Bank
  - AfDB – African Development Bank
  - IsDB – Islamic Development Bank
  - CAF – Development Bank for Latin America and Caribbean.

Of those listed, most relevant to our purpose are the first three institutions, which actively work in Ukraine and are better placed with their financial instruments for country specifics. For example, EBRD sometimes lend in local currency, by this eliminating the inherited exchange risk. Furthermore, those three institutions always provide consultancy assistance in preparing and implementing the loan-financed investments. Such expenditure is typically non-returnable (grant financed) and is significant contribution, given poor state of municipal companies in CEE countries.

Finally, there are a lot of microfinance institutions that could potentially provide funds. But, given large-scale of required financing for all municipal sectors in CEE, it is safe to say, that microfinancing institutions can hardly be source of reliable funding for these purposes.

2.2 Grants

Grant can be defined as non-returnable monetary allocation to implement a specific project by businesses or government institutions. The grant money can be advanced by any institution. It can be allocated by Government to another government unit or to business, by multilateral agency, by

IFI, commercial bank, etc. It is important to mention that grant in non-dilutive, in the sense that it does not in any way affect or dilute the company ownership.

Frequently, grants are used as instrument to soften the loans that are provided for a specific project. Financing organization will typically carve-out part of the project and finance it with a grant component. Combination of loan and grant is considered as providing good incentives for project implementation. All grant financed project are rare, because “free” money seems to provide adverse effect in utilizing the provided financing. In this situation, it is always recommended to use grant funding paired with loan financing in order to ensure proper incentives in place.

All the multilateral agencies and IFI banks mentioned in the section of Loans provide investment grants. Extent of the project coverage by grant is individual and depends on internal assessment of project needs.

2.3 Bonds

Bond is a fixed-term financial instrument issued by central governments, municipalities, and firms (corporations) in exchange of the promise to pay the face value of bond back in some years with return. The bonds are issues when issuer needs money and want to raise finance. The real value of bond fluctuates over time depending on its attractiveness to potential investors. The bond does not give ownership rights as opposed to shares.

In a sense, the bond can be considered a loan the buyer gives to the issuer. Typically, the bonds are called fixed-term instrument because interest on such loan is fixed upfront.

In principle, the utilities can also issue a bond for raising money. And this bond can be targeted to local or international investors. But whether such a bond will have a demand (that is, the investors will buy it), depends very much on credit rating that it will receive from credit agencies. And credit agency will collect all the info on company/municipality/government before issuing a rating. So that, unless the utility is in a good shape, it does not make sense for it to issue a bond, because such a bond will probably have poor rating and, therefore, demand from investors. That is, the ultimate goal in raising certain amount of money will not be achieved.

2.4 Shares

Shares or, otherwise, Equity is a form of finance issued by company when it wants to share a risk with investor in exchange for a share in company profit. When investor buys a share in the company, it becomes a co-owner in the company and, with it, has all the rights of owner, including voting rights over how company is run and its management. This means that if investor buys a share, he is likely to stay with the company and actively engage in its running. Over time, investor will receive dividends (share of company profit) or will want to have capital gain if he decides to sell the shares he owns.

Shares or equity can be raised in a different ways. Typically, it is traded on a stock market, where it can be freely bought or sold. Shares can be offered during company IPO (initial public offering). It can also be part of debt-to-equity swap, whereby part of the company debt is converted into shares in attempt to reduce company indebtedness and improve company balance sheets.

Company debt-to-equity ratio is important indicator of its financial health. That is why, some multilateral banks will buy equity stake in utilities in attempt to raise their equity-to-debt ratio, thus improving the company credit standing.

2.5 Guarantees

Guarantees can be in the form of either collateral (security deposit) or financial contract with third party.

The collateral is an asset, that borrower agrees can be taken over by the lender, if the borrower fails to repay the loan. As collateral, usually real estate (buildings) can be used. Recently, security deposits have been also utilised.

When borrower does not have what to offer as collateral or such a collateral is not accepted, he can ask third parties to guarantee the debt. In this sense, Guarantees are a financial agreement stating that financial debt will be repaid by lender to debtor. Guarantees are provided by third party (usually another financial institution) and represent form of commitment by that third party. In this sense, the financial guarantees are working like insurance policy and, most commonly, concluded as financial contract.

Guarantees can either provide partial or full loan repayment, or they can insure against certain types of risks (for example, regulatory or contractual risks). In latter case they are sometimes called Risk Guarantee instruments.

There are many types of guarantees. But, for our purposes, we are interested in so called development guarantees that are provided against financing targeting development needs and welfare. This kind of instrument can be provided by governments, multilateral financial institutions, development banks and their branches. Most of the guarantees by multilateral organisations are provided by two institutions via their respective banking arms:

- World Bank – provides wide range of guarantees. The most relevant is IBRD, IDA, and IFC credit guarantees that cover public sector borrowing debt obligations to private sector. Apart from this World Bank also provides so called Policy-based guarantees, where a member country is supported with guarantee against a borrowing to implement certain programme or policy. Finally, World Bank practices so called output-based aid, where the guaranteed financing is provided only if the project can demonstrate intended results.

- EU is providing guarantees via its institutional bank and “lending arm” EIB. Various guarantee instruments can be offered by EIB covering risks of single or multiple projects. The most relevant in our case is the guarantees that EIB is issuing for project finance. This can include funded or unfunded credit guarantees to enhance the credit quality and credit rating of investor. EIB also issues a so called counter-guarantee, but it is mainly targeted to borrowings with commercial banks.

- In the context of Danish financing probably also guarantees from Export and Investment Fund of Denmark (EIFO) are relevant. EIFO provides different types of guarantees. These include Contract Guarantee (insurance against losses when part of the project is delivered but not completed or did not get paid for), an L/C Guarantee (payment guarantee from your foreign bank to own bank), Investment Guarantee (protection against a loss caused by political instability in a country, when you have invested in a subsidiary abroad), and Bond Guarantee (protection against a loss when a customer makes unjustified call on your bond).

Frequently, when financing a project, especially those in municipal sector, a financing institution will require that it is supported by a sovereign guarantee. This is a guarantee provided by state, and can be in general term described as Government steps to discharge the liability of relevant companies in case of their default. In practical terms it means, that if the company cannot meet financial obligations vis-à-vis financing organization, the Government will step in and assume the liability of such a company. Guarantee provided by Government can also include commitment not to take certain actions (for example, to liquidate the company that takes a loan). Sovereign guarantee can specify the degree and boundaries of liability that Government undertakes (for example, it can specify that state will, subject to certain conditions, repay the principal and interest, but it will not be liable for any penalty or fine payment).

3 Overview of possible organizational setup

Organizationally, it is possible to finance projects in Mykolaiv using old municipal companies structure or to establish a new companies free of old obligations (so called SPV – Special Purpose Vehicle). That is, there are basically two possible organizational setup's:

- Use of old company structure – this option has an advantage, because the companies are already in place, including its management, the staff has specific functions allocated, and the procedural routines are well worked-out and familiar. However, this option also has a lot of disadvantages, the most important of which is its history, be it in terms of management or, most importantly, its financing structure, including loans. The companies are loaded with old debt, which makes it problematic for banks to advance new loans. Generally, the old financing structure can be hindering new financing, especially taking into account performance of those loans, which can be not so beneficial. Moreover, banks do not like to lend to companies which already have high levels of indebtedness.

- Use of SPV – from this point of view, the use of SPV structure has a lot of advantages. For general overview see Appendix B. Here we only list the benefits and disadvantages.

Main advantages of the SPV include:

- Separation of SPV from parent company. It gives it operational freedom and possibility to adapt to different situations, because the SPV possesses independent governance structure

- In case of failure of SPV project, the parent company does not have legal consequence

- SPV has no history – this sometimes can be preferred by financers, when parent company have a lot of financial problems

- Less bureaucracy – sometimes it is easier to establish a new company and write a lending documentation for it, than to restructure an existing company and to write lending documentation for company that has difficult past operations

- In some countries SPVs have different tax regime, so that, sometimes, SPV can be associated with tax benefits.

Key disadvantages of the SPV are:

- SPV should be possible and stipulated in country law, otherwise there is a risk that when established, an SPV will not be able to operate

- Interference from parent company – when delivered services of parent company and SPV are not different, and the staff involved in the process is more or less the same, it is difficult to avoid interference

- It is possible that tax regulation of SPV assets are different than tax regulation of parent company assets

- Bad performance of SPV can have negative effect on parent company reputation, although this risk is not very high in case of Ukraine. The same with liquidity, financing risks.

It should be noted that the regulatory framework is of utmost importance to ensure that the organizational setup, no matter which, actually ensures high performance. The framework shall establish the rules according to which all parties (individuals, organizations and businesses) act. The rules are laid down in primary and secondary legislation. They provide an environment for fairness, safety, transparency and accountability – all which is required to defend public interests and encourage healthy competition.

4 Recommendations

It is recommended addressing the question about organizational setup at first. In the case of municipal services the question is: Should the rehabilitation and delivery of services be based on the existing company framework, or should it based on a newly established SPV. The specific actions to be undertaken subsequently to make sure the population receives adequate services depend on the organizational setup chosen.

In this context it's important keeping in mind that a SPV is just a mechanism, a facility, which may be supported by grants, credits and guarantees to limit the risk – and also that the purpose of a SPV is to ensure certainty, while at the same time protecting against risks.

No matter which organizational setup that is chosen, it's key to ensure transparency in management and operations, application of clear procurement rules and a solid revenue stream.

Last, but not least it is proposed that municipal authorities reach out to financial institutions such as EIFO, EBRD and selected Ukrainian banks, depending on the municipal sector in question, to discuss the possible organizational setup associated with a particular investment package in a certain sector. Within the energy sector Ukrgasbank and PrivatBank, the two Ukrainian banks who have recently joined the EBRD's Energy Security Support Facility, may be of interest.

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Appendix B Special Purpose Vehicle, An introduction

B.1 Special Purpose Vehicle (SPV) in Project Finance

Special Purpose Vehicle (SPV) in project financing is a legal entity that is established for the purpose of acting as project owner.

The main idea behind creation of SPV is to shield the parent company balance sheet from the project financial risk and, vice-versa, to shield project from possibly parent company bankruptcy.

Another objective reached when project is financed by the debt is that parent company total indebtedness will not increase, in other words, investor is investing in project without investing into parent company.

The parent company is participating with the transfer to SPV those assets that are required to capitalize the project. This is, in a way, an investment of parent company into project, and frequently, this kind of transfer is stipulated in project financing documents.

B.2 Forms of SPV

The possible legal forms that SPV is created can be:

- A partnership
- Limited partnership
- Limited incorporated company
- Joint venture.

What form a particular SPV will take depends on regulatory, tax, legal, and accounting issues. The selected form should be specified in country legislation, it should have clear taxation and accounting rules, and it should be clear whether it is regulated business (and if yes, how) or not.

B.3 Functioning of SPV

Depending on the purpose of SPV creation, they can have different functions. But common features that they have are:

- SPV takes on board from parent company only those assets that are used in executing the project

- SPV assumes all the financing provided for the project, be it loan, syndicated loan, equity, grants, etc.

- SPV is established as new entity for each case, that is to say, it doesn't have history

- When drawing SPV documentation, it is important that SPV is setup as legal entity, allowed and regulated by the laws of a given country

- SPV should have operating manual, which describe all its functions, services, taken over from parent company
- SPV corporate activities are separate from parent company and kept as separate books (revenues, cost, staffing, financial obligations, assets, liabilities, etc.)
- Managing staff (especially directors) should be different for SPV and parent company; it is possible that on operating level staff will overlap, that is to do work for SPV as well as parent company.

B.4 Main risks and benefits

The main benefits of SPV are:

- Separation of SPV from parent company – all activities carried by SPV are isolated from parent company, for example, of the parent company gets bankrupt or have other financial problems, it does not concern SPV, because all SPV assets and financing, and sources of revenue are separate from parent company. In this way, the SPV is insulated from financial risks of parent company.
- In case of failure of SPV project, the parent company does not have legal consequences. That is to say that by creating SPV, parent company limits its legal liability.
- SPV has no history – this sometimes can be preferred by financers, when parent company have a lot of financial problems. So that, using SPV can be a way forward in financing a project, when parent company has bad history.
- Less bureaucracy – sometimes it is easier to establish a new company and write a lending documentation for it, than to restructure an existing company and to write lending documentation for company that has difficult past operations.

The main disadvantages of SPV are:

- SPV should be possible and stipulated in country law, otherwise there is a risk that when established, an SPV will not be able to operate. Usually, the country has different legislations that concern SPV, but the man once that establish the possibility of creating SPV are Corporate Law and Law on Public-Private Partnership.
- Interference from parent company – when delivered services of parent company and SPV not different and the staff involved in the process is more or less the same, it is difficult to avoid interference. Thus, the operations of SPV and assets used in the process should be very well defined, to provide as much ring-fencing the SPV as possible.
- It is possible that tax regulation of SPV assets are different than tax regulation of parent company assets. In this way, the parent company can have regulatory risk when creating an SPV.
- Bad performance of SPV can have negative effect on parent company reputation, although this risk is not very high in case of Ukraine. The same with liquidity, financing risks.

B.5 Documentation for SPV

When establishing an SPV it is important to know that it has four main types of documentation:

- Establishing (sponsorship) document – document, such as pre-development agreements, shareholding agreements, that specify an intention and parties entering into agreement to create SPV;
- Financing agreement – document specifying how an SPV will be financed, list of equity contributors and their rights, list of loan contributors and their rights, equity and lending agreements;
- Security agreements – documents specifying what kind of security is provided for SPV assets (project assets) and all finance providers;
- Project documentation – construction agreement, operation manual and agreement, sales agreement, cost agreement, customer contract, revenue sharing agreement, etc.

B.6 SPV and PPP

Typically, a PPP contract can also presume creation of SPV. In PPP there are two sides – public and private. The public side strives to deliver social goods, in the form of public infrastructure and services, while private side always wants to make profit. To reconcile this seemingly contradicting purposes an SPV is created as a "middle-man". Typically, each side has its role in SPV – public side provides assets, and private side makes investments. As such a project is created. Under such a structure, each side has its clear function outlined in SPV documentation.

The financing of SPV in PPP scheme can come from various sources. The two main sources are equity (private party) and loans (from banks). Equity is provided by private company. Sometimes government agency also owns shares in SPV in exchange for assets or land provided. Banks can lend SPV or to private party, thus avoiding government structure issues. In this way, risk is shared between private and public entities. Typically, banks provide short-term loans for project construction purposes, but could be that development bank provide loans with maturity covering entire life of the project. If bank is providing short-erm loan for construction only, SPV can consider to refinance it from pension funds or insurance companies, which typically have long term perspective, but require guarantees or credit insurance. This can be provided by the same banks, which advanced short-term construction loans.

So, to summarize, in PPP arrangement a legal structure of SPV helps both the private and public entities to protect their own assets and exposure when undertaking new project. At the same time, because SPV is not bound by the history (possibly bad history) of public and private parent organizations, it can raise financing easier.