

## European Fund for Sustainable Development (EFSD) Guarantee

**Title: Investment Window - Sustainable Cities**

### 1. Policy Rationale

**Background analysis:** This window will contribute to achieving the United Nations' Sustainable Development Goal (SDG) #6 "Clean water and sanitation", SDG #11 "Make cities and human settlements inclusive, safe, resilient and sustainable", SDG #10 "Reduce inequality within and amongst countries", SDG #12 "Responsible consumption and production" and SDG #13 "Take urgent action to combat climate change and its impacts". It will be able to cover a range of investments (mainly climate-smart) in several sectors (see below) at municipal level as well as city maintenance operations.

Cities account for more than 80% of global GDP (88% by 2025 estimates). Supporting investments by municipal authorities in enabling infrastructures is key to sustainable, low-carbon and climate resilient economic growth and poverty alleviation. Investment windows set up in this area would explore innovative mechanisms to address the challenges of sustainable urban development faced by partner countries. This could include a range of priority investments falling within the municipal infrastructure sectors of sustainable and smart urban mobility, water, sanitation, waste management, food supply, circular economy and nature-based solutions, air quality, renewable energy services and energy efficiency, while mitigating and adapting to climate change and building urban resilience including through disaster risks reduction measures.

Whilst cities geographically cover a small part of the world, an estimated 55% of the world's population lives in urban settlements (and projected to reach 65-70% by 2050) and their physical and ecological footprints are much larger. Research indicates that they already account for up to 70% of energy use and 80% of Greenhouse Gas (GHG) emissions, as well as being significant sources of local air and water and soil pollution, waste generation and land use change. Cities also concentrate the visible negative impacts of climate change: rising sea levels, storm surges, heat waves, extreme precipitation and flooding, water scarcity and droughts. These negative impacts are set to rise over time as a result of pressure from increasing urbanisation and climate change. At the COP21 in Paris, more than 450 cities with a combined population of nearly 1bn people pledged to reduce emissions by more than 50% in around 15 years, but only a small percentage of cities have the financing, analytics or capacity for implementing policies fostering a transformative shift towards an effective climate-resilient low-carbon economy and society. The Global Covenant of Mayors for Climate and Energy is a practical example of an alliance of local governments and approximately 7500 cities, who share the vision of combatting climate change and its impacts and moving to a low-carbon society. Under the Global Covenant of Mayors for Climate and energy, cities and local governments representing a population of over 681 million people could collectively reduce 1.3 billion tons of CO<sup>2</sup> emissions per year from

business-as-usual in 2030<sup>1</sup>. Together, cities committed to the Global Covenant of Mayors have the potential to achieve a cumulative reduction of 46 Gt CO<sub>2</sub>e by 2050.

Underinvestment and low maintenance in municipal infrastructure is also common place, with revenue streams affected by losses in/illegal connexions to the technical networks. They are also often frequently exacerbated by end user tariffs which are significantly below cost recovery levels. For instance, 24 countries in Sub-Saharan Africa, accounting for 70% of Africa's GDP, have spent around 2% of GDP annually between 2009 and 2015 to build, rehabilitate, or improve the existing capacity of infrastructure (in comparison East Asia countries reach levels of public capital spending that exceed 10% of GDP)<sup>2</sup>.

In the Neighbourhood, but also in Sub Saharan Africa, these shortages are particularly relevant in small and medium-sized cities where local administrations, in the context of decentralisation, have taken over competencies from the national governments, and now need to reinforce their human and financial resources to implement the related development policies. This is also relevant in a context of migration and forced displacement where such cities are particularly exposed to sudden scaling up of their basic services.

Lastly, most cities in sub-Saharan Africa and the Neighbourhood regions need to increase their currently limited capacities to access to sufficient, long-term financing and credit. The market for long-term municipal borrowing has a relevant growth potential, banks need an enabling financial and economic environment to improve their potential to offer loans matching the economic life of assets and their acceptance to take sub-sovereign risks. At the same time, debt sustainability concerns need to be addressed.

Several initiatives have been implemented in the Neighbourhood regions to help city tackle climate change challenges. In the East the most relevant is the Covenant of Mayors initiative, whose signatory cities commit to the implementation of sustainable energy policies, as well as local climate change mitigation and adaptation activities. In the South-Mediterranean region, the CES-MED (Cleaner Energy Saving Mediterranean Cities) project will pave the way for launching the Covenant of Mayors in North Africa.

As African cities will remain major energy consumers and major hotspots of vulnerability to the impacts of climate change and environmental degradation, local authorities are critical partners in a bottom-up transition to a global low-carbon and climate resilient green economy and society. The Covenant of Mayors in Sub-Saharan Africa represents one of the regional Covenants that form part of the Global Covenant of Mayors for Climate and Energy.

---

<sup>1</sup> Based on data reported to the Global Covenant of Mayors for Climate & Energy. EU Covenant city data accessed on September 24, 17.

<sup>2</sup> *Africa Pulse, World Bank, Vol 15, April 2017*

**EU Policy objectives:** In line with the new European consensus on development and the revised European Neighbourhood Policy<sup>3</sup>, and following the international principles adopted in the Agenda 2030 and the New Urban Agenda, potential investment windows could promote the following objectives: i) Promote a territorial and transversal approach that fit with local realities and allow to reinforce urban-rural linkages; ii) Build cities' resilience to shocks and harness opportunities for a low-emission and climate-resilient green economy; iii) Promote inclusive sustainable urban development to address urban inequality iv) Create a catalytic impact on climate change adaptation and mitigation, decent job creation (in particular for youth and women) and balanced development addressing climate and environmental challenges through private sector investments at municipal level v) Empowerment of accountable and autonomous local authorities to deliver an integrated, multi-scalar and incremental development as well as to better address inequalities within countries, notably those impacted by high mobility rates.

Private investment supported by the EFSD will be additional and will not replace essential public services provided by the government.

**Geographic area:** Sub-Saharan Africa and the Neighbourhood regions. The inclusion of LDCs/landlocked/fragile and conflict affected countries within proposals will be positively viewed.

**Domain:** Municipal infrastructure and services.

**Sectors of intervention:** Priority investments falling within the municipal infrastructure sectors of sustainable urban planning and smart mobility, water, sanitation, waste management, renewable energy services and energy efficiency, resilient infrastructure and buildings (including social housing). The existence of Sustainable Energy and Climate Action Plans or equivalent plans would be considered an advantage.

## **2. Operational concept**

The EFSD guarantee shall be structured in such a way as to lower investment risks for long-term financing and create the right conditions to contribute to the provision of municipal services of appropriate quality. It is envisaged that a) The IFIs will work jointly with municipalities to assess and prioritise their main climate, environmental and social challenges and mobilise corresponding investments (climate-friendly investments that would generate a measurable, beneficial social and/or environmental impact) and respecting fiscal standards; and b) more innovative and complex transactions as well as greater engagement with the private sector (when driven by efficiency considerations) will be the main feature of financial products proposed under this window.

---

<sup>3</sup> [https://eeas.europa.eu/headquarters/headquarters-homepage/330/european-neighbourhood-policy-enp\\_en](https://eeas.europa.eu/headquarters/headquarters-homepage/330/european-neighbourhood-policy-enp_en)

**Type of operations:** The EFSD Guarantee may be used to cover the risks for loans, guarantees, counter-guaranties, capital market instruments, and any other form of funding or credit enhancement, insurance, and equity or quasi-equity participations. Different types of eligible operations may include:

- Guarantees provided in the framework of infrastructure-focused operations implementing low-carbon and climate resilient investment plans in the field of sustainable and smart urban mobility, urban planning, solid waste management, water, sanitation, sustainable energy services, infrastructure and green building. This includes public-private partnership schemes (PPPs). Project bonds and even “green” project bonds could also be tentatively explored under these schemes.
- Guarantees provided to grant further access to private finance at city level (targeting private institutional investors as a priority):
  - Through municipal bond issuance by cities (introducing credit enhancement measures)
  - Through special purpose vehicles covering several cities to mutualise risks (introducing credit enhancement measures). The vehicles could in return issue bonds, attract equity investments etc.
  - Through the creation of the right conditions for lending to the local public sector by commercial banks (longer loans terms matching infrastructure maturities).
- Guarantees provided to grant further access to private finance to local utilities, through bond issues/equity investments (directly or through special purpose vehicles bundling multiple investment projects)
- Guarantees provided to private sector operators working with municipalities as an incentive to roll out climate smart technologies and techniques (grey-water recycling; rainwater harvesting, smart metering solutions, energy efficient street lighting etc.).
- Under specific circumstances and when strictly needed to achieve impact development goals that otherwise wouldn't be possible, it may be considered guarantees provided to facilitate direct borrowing of cities or local governments from eligible counterparts.

The operations listed above are indicative and non-prescriptive/exhaustive. Priority will be given to inclusive initiatives offering high sustainable low-carbon development impact (including job creation, youth and women empowerment), optimising leverage and cost efficiency, and mobilising funding from multiple sources in fragile countries.

Measures for aligning the interests of the different stakeholders - including fund managers and investors - should be considered in line with relevant market practice. Such measures shall be transparent and will take into account the policy and financial objectives of the relevant instrument.

**Type of risks:** Risks to be mitigated may include: i) Commercial risks (payment risk, performance risk, etc.); ii) Political and country risk (expropriation, coup d'état, civil war, etc.); iii) Legal and regulatory risk (change in law, cancellation of license, tariff adjustments, etc.); iv) Currency risks (e.g. exchange rate fluctuation, convertibility,

transferability, etc.); and v) Climate change and environmental risks (e.g. droughts, flooding, extreme weather events, temperature rises, etc.)

**Expected Additionality:** i) Private sector investments mobilised, both locally and internationally; ii) Sustainability: terms of commercial financing improved through extended maturities and lowered spreads, allowing for affordable long-term investments; iii) EU's policy objectives met as regards climate change mitigation and environmental sustainability at municipal level iv) (Eco-)Innovation aspects positively considered, in particular for those projects/ business models that cannot be undertaken because of their perceived high risk, high initial cost, untested regulatory framework, untested technology etc.

**Envisaged Impact:** i) Increase in the proportion of population that has access to basic services; ii) Direct and indirect decent jobs' net creation (operating and benefitting from the use of infrastructures); iii) EU climate, environmental and social standards are targeted or met, including using Environmental Impact Assessments, Strategic Environmental Assessments, Sustainable Energy and Climate Action Plans, Climate Risk Assessments and Best Available Techniques; iv) Local pollution, waste generation and GHGs levels from the relevant municipal activity are reduced through investments to promote climate change adaptation and mitigation activities and low pollution resource efficient technologies.

When relevant, indicators as approved in the context of EUBEC Platform and included in the list in Annex 2 will apply. Additional sector indicators will be agreed at the level of specific proposals, such as:

- Hours per day of new electricity supply
- Liters per day per inhabitant of water supply.
- Percentage of waste water collected and treated.
- Tons per day of waste collected, treated and disposed.
- Percentage of works executed following the recommendations of a sound EIA.
- Average concentration of air pollutants.
- Percentage of works executed following integrated urban planning.
- Events (flooding, etc.) in disaster prone urban areas.

Disaggregation by gender (when applicable and feasible) shall be pursued.

**Complementarity/Risk of potential overlap with other Investment Windows:**

There are complementarities with the "Digital for Development" Investment Window and with the "Sustainable Energy and Connectivity" one. As quality of municipal services is also a core element of the local business environment, interventions under this window can facilitate those undertaken under the "MSME Financing" window. There is a low risk of overlap with other Investment windows.

**Expected Minimum Private Sector Involvement:** at least 30-40% of final investment volumes, on a portfolio (PIP) basis, are expected to be financed by the private sector (including commercial banks).

### **3. Supporting Policy Actions (links to pillars 2 and 3)**

Links will be established to adequately coordinate between the investment pillar (pillar 1) and enabling policies (pillar 3) to foster conducive business environment and investment climate as well as to technical assistance (pillar 2). Implementation of this window may thus be accompanied by sector policy dialogue with the partner countries and by in-country reform processes supported by the Commission.

The most relevant policy actions and requirements may relate to:

- Defining or reinforcing National Urban Policies (NUPs) which outline intergovernmental arrangements and clarify roles at national and local level, including through the integration of climate change considerations, as NUPs are key instruments to coordinate national and local climate policies for the implementation of the Paris Agreement.
- Defining or reinforcing sector policies providing a framework within which private sector can play a role (e.g. water, waste,...). As an example, promoting the Sustainable Urban Mobility Plans (SUMPs) approach, with special attention given to the linkage of city transport infrastructure to national and regional priorities, should be encouraged.
- Reforms in the field of domestic resource mobilisation and municipal finance.
- Legal and regulatory reforms allowing private institutional investors to pursue long-term low-carbon investment strategies, including at sub sovereign level.
- Utilities revenues support and reform (where appropriate) to achieve financial sustainability at the municipal level with due consideration to affordability issues and mechanisms to protect the more vulnerable.
- Legal frameworks that enable low-emissions climate-resilient improvements at the municipal level in a financially sustainable manner.
- Policies to promote low-carbon resource efficient (energy efficiency, water saving,..) in particular in the building sector by developing, adopting and enforcing "green building codes" legislation.
- Promotion of transparent utility practices as well as demonstrating the benefits of well-structured public/private partnerships.
- Policy dialogue activities and reforms (encompassing legislative and institutional aspects) which target effective and controlled private sector participation through e.g. incentive based outsourcing or management contracts.

In line with the policy actions technical assistance may include:

- Capacity building to translate NUPs at local level into urban planning, through a participatory and territorial approach including all stakeholders at city level, and corresponding sound and consensual low-carbon climate-resilient investment plans.
- Capacity building on various aspects of sub-national infrastructure financing (including private concessions) to enhance the planning and implementation capacity of sub-national governments, regulatory capacity of government agencies and credit analysis capacity of commercial lenders/institutional investors.

- Assisting sub-national governments to institute borrowing/investment programs in a financially sustainable manner, and to compile information packages required by creditors and rating agencies.
- Capacity building to strengthen arrangements for involvement of private sector at local level. This could also encompass reinforcing the capacities of private sector at all levels (not only SMEs) to provide sound low-carbon sustainable services/equipment/works to the public sector/local government/consumers (with due consideration to TA provided under "MSMEs financing" window).
- Reinforcement of the legal framework and/or the capacities of local governments to manage and supervise municipal utilities.
- Awareness activities on the benefits of sustainable production and consumption for a low-carbon economy: need to pay for basic services, sorting at source, etc. at all levels (public, institutional, private sector...).

## **ANNEX 1: Examples**

### ***Partial Credit Guarantee for Municipal Bond in Johannesburg***

This bond issue was an essential part of the City's financial diversification strategy as it allowed them to tap into the institutional investor market. Although the City sought funding beyond 10 years, they faced a constraint in that they could not issue beyond 6 or seven years at an acceptable price without external credit enhancement. Consequently, the city utilised a partial credit guarantee in order to enhance the credit rating of the bond, allowing for an extension of the bond maturity. The enhanced bond was rated AA-.za (Fitch), a three notch upgrade from their standalone rating of A-.za and the issue was oversubscribed 2.3 times, showing strong market endorsement of both the issuer and the enhanced structure. The partial credit guarantee covered 40% of the principal and was issued by IFC and the Development Bank of Southern Africa (DBSA).

Market development in South Africa (SAR)

- New asset class – creates a benchmark for long-tenor municipal debt in SAR
- New instrument for DBSA, with potential replication in other cities

### ***Partial Credit Guarantee for pooled Municipal Bond in India***

The Water and Sanitation Pooled Fund (WSPF) in Tamil Nadu issued a pooled bond to facilitate access to long-term domestic capital markets for small and medium Urban Local Bodies (ULBs) to finance water and sanitation services.

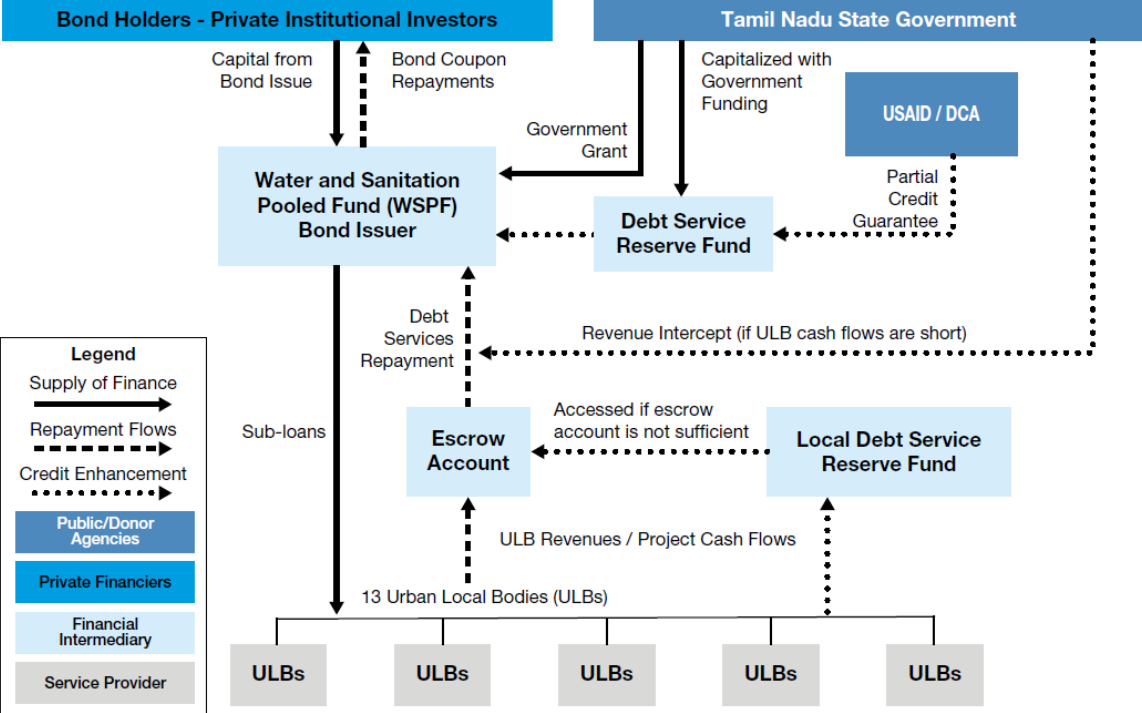
This enabled a grouping of 13 ULBs to overcome high transaction costs and mobilize funds through a single bond issuance. Debt was repaid from project cash flows and from general ULB revenues. A multi-layered credit enhancement package was designed in order to extend the maturity of the bond and increase investor confidence.

The different credit enhancement mechanisms included a debt service reserve fund capitalized by the state government, creation of individual ULB escrow accounts, a local debt service reserve fund, a State revenue intercept mechanism, and a partial credit guarantee from USAID.



The general scheme is outlined below:

**FIGURE 1** Pooled Municipal Bond Issuance in Tamil Nadu, India: Financial Structure



## ANNEX 2: Indicators

SUSTAINABLE ENERGY		
OUTPUT INDICATORS	UNIT	DEFINITION
New connections to electricity	Nr.	Number of new connections to the grid. Only new connections resulting from a project are counted; those already connected to the grid and receiving improved services through a project are not counted.
OUTCOME INDICATORS	UNIT	DEFINITION
Population benefitting from electricity production	Nr. of households	The number of households which are estimated to benefit from new electricity supply from the project.

TRANSPORT		
OUTPUT INDICATORS	UNIT	DEFINITION
Length of new or upgraded public transport lanes.	km	Total length of public transport lanes including bus lane, tramline or metro tracks built or upgraded.
OUTCOME INDICATORS	UNIT	DEFINITION
Public transport users	Nr/year	Total public transport users indicating those shifted from non-public transport modes to public transport modes as a result of the project.

WATER AND SANITATION		
OUTPUT INDICATORS	UNIT	DEFINITION
Length of new or rehabilitated water supply pipes	Km	Length of water mains and distribution pipes installed/ upgraded. All sizes of pipes intended to transport water for urban water use expressed in their aggregate length in the network, irrespective of pipe diameter, comprising mains as well as reticulation pipes.
Length of new or rehabilitated sewer pipes installed	Km	Length of collectors and sewers installed or upgraded. All sizes of sewer pipes expressed in their aggregate length in the network, irrespective of pipe diameter, comprising mains as well as reticulation pipes.
New connections to water supply	Nr	Number of new connections to the water network. Only new connections resulting from a project are counted; those already connected to the network and receiving

		improved services through a project are not counted.
Water treatment capacity	M3/day	Maximum amount of water that the new or improved treatment plant can process. This indicator reflects the total new or additional capacity of treatment plant independently of its production during operation.
Wastewater treatment capacity	M3/day	Maximum amount of waste water that the new or improved treatment plant can process. This indicator reflects the total new or additional capacity of treatment plant independently of its production during operation.
OUTCOME INDICATORS	UNIT	DEFINITION
Population benefitting from safe drinking water	Nr of households	Urban or rural population using a safe drinking water supply, as defined by international standards.
Population benefitting from improved sanitation services	Nr of households	Urban or rural population with access to improved sanitation services, as defined by international standards.
Potable Water Produced	M3/day	Amount of potable water produced, independently of the maximum capacity of the network.
Wastewater Treated	Population equivalent "p.e."	Amount of wastewater treated, independently of the maximum capacity of the treatment plant.

PRIVATE SECTOR DEVELOPMENT		
OUTCOME INDICATORS	UNIT	DEFINITION
<i>For both direct and, where feasible, indirect operations:</i> Number of jobs sustained (resulting from the project)	FTE	Number of full-time equivalent employees at the end of the reporting period. Includes full-time equivalent worked by seasonal, contractual and part time employees. Part-time jobs are converted to full-time equivalent jobs on a pro rata basis.

SOCIAL HOUSING		
OUTPUT INDICATORS	UNIT	DEFINITION
New and/or refurbished habitable floor area	Square meter	Square meters of new and/or refurbished social housing.
OUTCOME INDICATORS	UNIT	DEFINITION
Population benefitting from improved housing conditions	Nr. of households	Number of households benefitting from improved housing conditions.

<b>CROSS SECTOR INDICATORS</b> (Application subject to current practices and methodologies by Financial Institutions)		
<b>INDICATORS</b>	<b>UNIT</b>	<b>DEFINITION</b>
Jobs sustained / created	Number (FTE)	Jobs sustained / created as a result of the project (methodology used to be made transparent)
Total number of beneficiaries	Nr.	Estimated number of people with improved access to services (financial services, social and economic infrastructure, etc.)
Number of beneficiaries living below the poverty line (whose living conditions are improved by the project)	Number (and/or %)	sub-group of the above (if applicable), (to be made transparent which reference point has been used, e.g. national or international definitions of poverty)
Variation CO2 / Greenhouse gases	CO2 ktons equivalent / year	Amount of CO2 / GHG emissions generated for a typical year of operation by a project compared with the baseline scenario.