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## Credit enhancing output based aid

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**Abstract:** This paper presents options for using World Bank guarantee instruments to enhance the credit worthiness of government **Output Based Aid** (OBA) payments to an infrastructure service provider. OBA payments are targeted, performance-based subsidies provided when full cost recovery through direct user fees is not justified due to externalities, not possible due to affordability constraints, or not practical due to the high costs of levying such fees. The main focus of the paper is not on the policy aspects of subsidy provision, but on the use of OBA payments as one element of a cash flow for project financing, the other element being user fee payments. Structured in the right way, OBA payments can be made creditworthy and can make infrastructure transactions financeable in the market place. In many countries, government payments are not considered reliable and are assigned a low credit rating by financial markets and investors. In these cases, the quality of OBA payments needs to be enhanced, i.e. lifted to a higher level, if they are to become a creditworthy component of a project's cash flow. World Bank guarantee instruments can be used to achieve this objective. The two principal options analyzed in this paper are partial risk guarantees to mitigate government payment risks for individual projects, and partial credit guarantees to enable governments to mobilize funding for a subsidy pool that would provide OBA payments to multiple projects.

**Resumen:** El esquema de pago de subsidios dirigidos en función a resultados (SFR) es una estrategia de desarrollo para apoyar el mejoramiento en la provisión de servicios públicos - tales como agua potable y saneamiento, electricidad, transporte, telecomunicaciones, salud y educación - donde consideraciones de política social justifican el uso de fondos públicos para complementar o reemplazar el pago por servicios por parte del consumidor final. Los esquemas SFR está basado en la contratación de la prestación de servicios con terceros - usualmente el sector privado - con el pago del subsidio (complementario o total) en función de la evidencia en la prestación del servicio. SFR es un mecanismo para la prestación servicios de infraestructura enfocado a la mejora en la efectividad del gasto público (o fondos de asistencia) hacia las clases más pobres en países emergentes. El principal desafío es lograr que ese gasto público (o asistencia) llegue efectivamente a los pobres, que los servicios se presten eficientemente, y que se utilicen en forma que permitan movilizar financiamiento privado adicional.

Estructurar financieramente proyectos cuyos ingresos tienen un alto componente de dependencia del pago de subsidios por parte de una institución de gobierno en países emergentes conlleva riesgos importantes relacionados con el carácter de la fuente de dichos ingresos. Para estructurar dichos proyectos de forma de que puedan acceder financiamiento privado es necesario mitigar este tipo de riesgos (i.e., riesgo de pago por parte de la institución de gobierno, riesgo regulatorio y riesgo político). El presente documento aborda la forma en que garantías parciales de riesgo y garantías parciales de crédito contribuyen a cubrir estos riesgos y a hacer factible el acceso de este tipo de proyectos a los mercados crediticios privados.

This paper is a product of work done under the auspices of the Infrastructure Economics and Finance Department of the World Bank and the Global Partnership on Output-Based Aid (GPOBA). GPOBA is a trust fund established in January 2003 by the UK's DFID and the World Bank. Its purpose is to fund, design, demonstrate and document output-based aid (OBA) approaches to support the sustainable delivery of basic services to those least able to afford them through the provision of explicit performance-based subsidies. Output-based aid (OBA) is a strategy for supporting the delivery of basic services - such as water, sanitation, electricity, transport, telecommunications, health and education - where policy concerns would justify public funding to complement or replace user fees. At the core of the OBA approach is contracting out service provision to a third party - usually the private sector - with payment tied to the actual delivery of services.

## 1. INTRODUCTION

This paper presents options for using World Bank guarantee instruments to enhance the credit worthiness of government **Output Based Aid** (OBA) payments to an infrastructure service provider. OBA payments are targeted, performance-based subsidies provided when full cost recovery through direct user fees is not justified due to externalities, not possible due to affordability constraints, or not practical due to the high costs of levying such fees. The main focus of the paper is not on the policy aspects of subsidy provision, but on the use of OBA payments as one element of a cash flow for project financing, the other element being user fee payments. Structured in the right way, OBA payments can be made creditworthy and can make infrastructure transactions financeable in the market place. In many countries, government payments are not considered reliable and are assigned a low credit rating by financial markets and investors. In these cases, the quality of OBA payments needs to be enhanced, i.e. lifted to a higher level, if they are to become a creditworthy component of a project's cash flow. World Bank guarantee instruments can be used to achieve this objective. The two principal options analyzed in this paper are partial risk guarantees to mitigate government payment risks for individual projects, and partial credit guarantees to enable governments to mobilize funding for a subsidy pool that would provide OBA payments to multiple projects.

## 2. OBA SUBSIDIES AS CASH FLOW COMPONENTS IN INFRASTRUCTURE FINANCING

One important reason for a government to entrust infrastructure service provision to a private operator is to tap commercial financing resources which do not impact on the government's budget. This is particularly important when improvement of infrastructure services is dependent on substantial up-front investments which otherwise would have to be financed within the often restricted government budget framework. However, a key condition for mobilizing market financing for private infrastructure investments is a dependable and creditworthy revenue stream that will cover the full cost of service provision plus a reasonable return to equity shareholders and by the same token generate sufficient cash to ensure all operational expenses, debt service payments and dividends. If revenues consist exclusively of user fees, the financing decisions will depend substantially on the assessment of credit quality factors such as customer base, payment discipline, collection efficiency,

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The findings, interpretations, and conclusions expressed herein are those of the authors and do not necessarily reflect the views of the International Bank for Reconstruction and Development/The World Bank and its affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent. The World Bank does not guarantee the accuracy of the data included in this work

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billing system etc. Under specific circumstances a private operator's revenues will consist of user fees as well as government subsidies, if end-user tariffs cannot be set at full cost-recovery levels. The private operator will then mobilize project financing based on two types of cash flows, i.e. end-users' payments of an affordability tariff, and contractually defined subsidy transfers from a government or government entity, e.g. public utility. While each of these cash flows has different characteristics and implies different risks, commercial project finance providers will take a view on the combined risk before committing financing sources.

In many infrastructure service schemes, particularly in developing countries, full cost recovery through user fees may not be possible or may be difficult to implement due to users' inability or unwillingness to pay (e.g. for new water connections). In those instances, a government subsidy can often be justified based on positive externalities or merit goods considerations. This subsidy will also be necessary for an infrastructure investment to achieve financial viability. It can be broadly structured in two different ways. One is an initial government capital grant during the main investment phase, i.e. typically the first few years. This reduces the initial project financing requirements, and consequently the level of user fees/revenues necessary for full cost recovery. The second structure is based on initial project financing entirely through private sources without government capital grant. This leads to a higher level of project revenues necessary for full cost recovery. In this situation the government will have to provide periodic subsidies after the initial investment phase (i.e. during the project's operations) in order to keep user fees at affordable levels. The project's cash flow would then consist of user fees and subsidies, and would be sufficient to cover all its financial obligations, including operating costs, debt service and equity return.

Capital grants may sometimes be the preferred way for a government to provide a subsidy for large, lumpy investments since their budgetary impact can be estimated with some confidence and is of short-term nature. However, governments and aid institutions are increasingly turning towards the provision of periodic subsidies when full cost recovery through direct user fees is not possible. Structured in the right way, as "output-based aid" (OBA), these present a much better tool to introduce performance incentives, accountability and adequate targeting into infrastructure service provision. They can be provided to cover part of a project's operating expenses and their level can be linked to the operator's performance in achieving pre-defined service parameters, such as hours of water supply per day. The service parameters can be designed to specifically target poorer segments of the population, e.g. by putting priority on service improvement in poor neighborhoods. OBA payments can also be linked to the operator's performance in implementing smaller follow-up investments (e.g. additional power connections) which again can be used to target poorer parts of the population. Nevertheless, subsidies structured as OBA payments raise different challenges from capital grants since they form part of a project's future cash flow that needs to meet certain creditworthiness standards as basis for the mobilization of commercial financing. But in many countries, governments are not considered creditworthy or are assigned a very low credit rating by financial markets and investors. In these cases, the quality of government subsidies needs to be enhanced, i.e. lifted to a higher level, if they are to become a creditworthy component of a project's cash flow.

### **3. OBA CREDIT ENHANCEMENT THROUGH WORLD BANK FINANCING**

OBA schemes that provide government subsidies based on disbursements under development assistance programs (e.g. IBRD Loans or IDA Credits), can be highly creditworthy due to

the development agencies' rating and credibility, provided the disbursement mechanisms are set up to ensure a subsidy payment stream in accordance with the operating contract.<sup>1,2</sup>

However, financing of subsidies from development assistance will often not be possible. External assistance agencies, including the Bank, will normally not commit themselves to indefinite support of a subsidy scheme, but will expect subsidy payments to be either phased out (the transition model) or to be sustained after a period of time through domestic budgetary resources (the long-term subsidy model). This means that long-term subsidies cannot be ensured from external assistance, and even under the transition model, aid resources may not be available for the whole transition period if it exceeds the project implementation periods that aid agencies normally commit to (for the Bank in the range of 5-6 years). Moreover, governments may not wish to borrow specifically for subsidy payments, or country programs of aid agencies may not be able to accommodate additional resources for that purpose. Under all these circumstances OBA payments will need to be financed directly from government budgets and their credit quality will often need to be raised in order to provide an adequate basis for the mobilization of market financing for the initial investments.

#### 4. CREDIT ENHANCEMENT THROUGH WORLD BANK GUARANTEES

The World Bank's guarantee instruments can be used to offer credit enhancement for OBA subsidies<sup>3</sup>. They have been developed to facilitate the mobilization of commercial financing, both for private investment projects, and for public funding purposes. Their main function is to mitigate the risks associated with non-compliance by governments of contractual obligations. Given the Bank's unique relationship with its member countries and their governments, it is well equipped, and often in a better position than the private sector, to backstop certain government-related obligations. A Bank guarantee, coupled with the mandatory government counter-guarantee, can thus be used to raise the creditworthiness of an OBA scheme as it reinforces the incentives for governments to comply with their contractual payment undertakings. The World Bank offers two kinds of guarantees that could both be applicable to the enhancement of OBA structures: partial risk guarantees and partial credit guarantees.<sup>4</sup>

1. **Partial Risk Guarantees** (PRGs) ensure debt service payments by a private company in the case of default resulting from the nonperformance of contractual obligations undertaken by governments. PRGs can be arranged for borrowers in IBRD as well as in IDA countries.<sup>5</sup> Under the PRG concept, the Bank has developed two guarantee structures that are suitable for different types of transactions.
  - **The PRG limited recourse structure** guarantees commercial debt or shareholder loans to a private company. It is particularly suited to project finance transactions.

1 OBA payments from aid resources are not addressed in detail in this note. They are currently subject to a mainstreaming effort within the Bank which defines the operational implications of such schemes. Similarly, under the donor trust fund GPOBA a window has recently been introduced, which is specifically designed to finance OBA subsidy payments.

2 Credit enhancement for OBA schemes would also be conceivable through a contingent IBRD Loan or IDA Credit that could be drawn upon in case of a subsidy payment default. However, a contingent loan/credit would have no obvious advantages for a government compared to borrowing directly for the subsidy since it would constitute part of the government's debt and thus carry full weight for budget accounting purposes.

3 Under recently modified operational procedures, guarantees offer the advantage of a weighting of only 25% in a country's lending program compared to IBRD Loans or IDA Credits. This means that a US\$ 100 million guarantee counts as only US\$ 25 million in the lending program and thus leaves US\$ 75 million headroom for additional direct borrowing from the Bank.

4 As a third type, the Bank also offers policy-based guarantees which support borrowing for an overall Government reform program and are thus not suitable for OBA schemes.

5 Under exceptional circumstances, IBRD guarantees can be arranged for lenders to a private project in an IDA country (IBRD enclave guarantees). They are not discussed in this paper as they are designed for specific projects that are typically profitable and generate foreign currency revenues. This type of guarantee would thus not lend itself to OBA schemes.

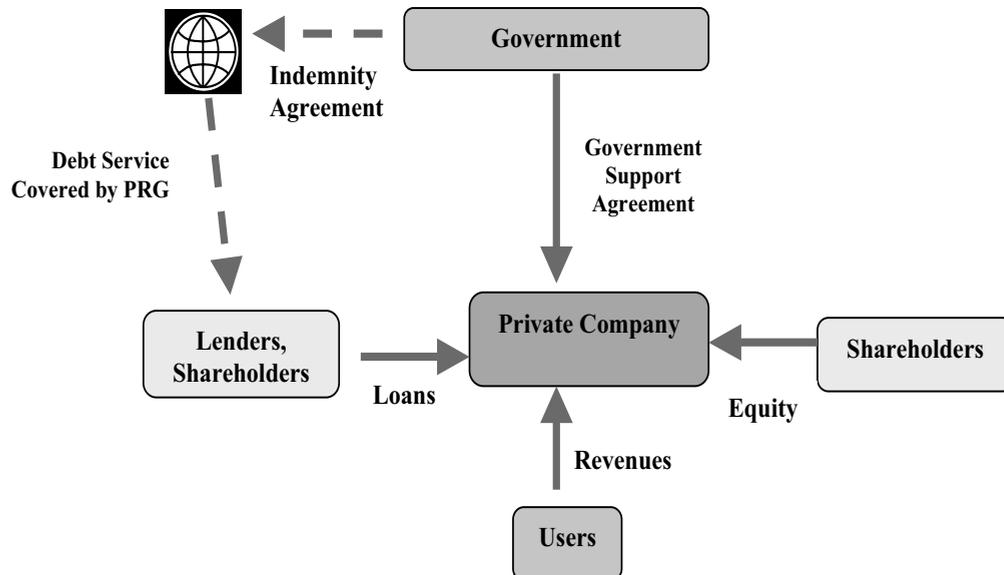
### Box 1; Partial Risk Guarantee – Limited Recourse Structure

**PRG Coverage:** Unpaid debt service payments on a commercial or shareholder loan made to a private company.

**Risk Coverage.** Political, government performance, regulatory and associated risks.

**Mechanism:** The PRG can be triggered if a debt service shortfall occurs as a result of a default on government contractual obligations or a political event as stipulated in the relevant agreements.

### PRG - Limited Recourse Structure



- The *PRG letter of credit (L/C) structure* is designed to protect a private company against cash flow shortfalls caused by a government default on its contractual commitments. It is particularly suited to smaller privatization transactions with government payment undertakings.

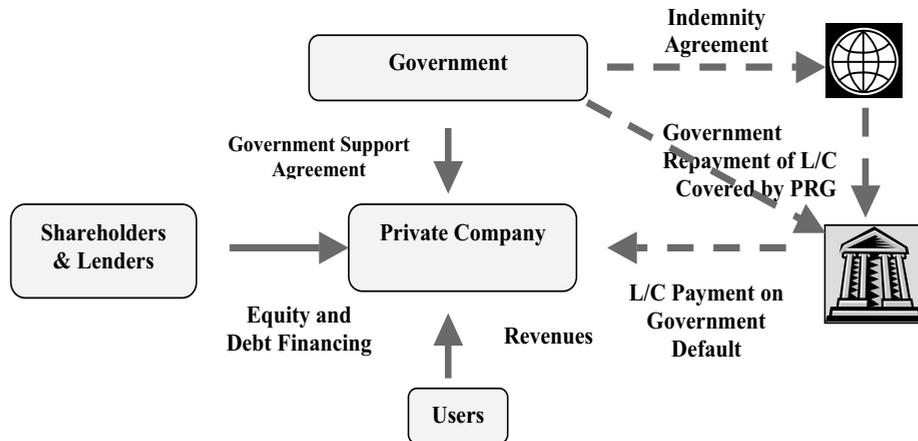
**Box 2: Partial Risk Guarantee – L/C Structure**

**PRG Coverage:** Cash flow shortfalls of a private company as a result of government default, including government contractual payments.

**Risk Coverage:** Political, government performance, regulatory and associated risks.

**Mechanism:** The PRG can be triggered if there is a default on government contractual obligations, including payment commitments, leading to cash flow shortfalls of a private company up to pre-agreed amounts. In this case, the L/C bank would make the payment and receive reimbursement by the World Bank if the government fails to repay the L/C bank within a stipulated period.

**PRG - Letter of Credit Structure**



2. *Partial Credit Guarantees* (PCGs) cover private lenders against all risks during a specific period of the financing term or for a pre-defined portion of the debt. PCGs are specially designed to extend and improve market terms for borrowing of public entities, i.e. to facilitate financing of public investments. PCGs, which are not available in IDA countries, could thus be used for OBA credit enhancement in IBRD countries if a government or government entity borrows money from financial markets to finance OBA payments. However, governments are unlikely to increase their indebtedness simply to finance subsidies for individual projects. For this reason, the use of PCGs is discussed in this note only in the context of subsidy pools for multiple projects to which a government may wish to contribute part of the initial funding (Chapter E).

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## 5. OBA CREDIT ENHANCEMENT FOR INDIVIDUAL PROJECTS

For OBA schemes, credit enhancement needs to be structured to backstop as directly as possible contractual government subsidy payments to the project company. This will increase the perceived reliability and creditworthiness of the project company's revenue stream and provide the necessary comfort to all project investors and lenders. Credit enhancement through World Bank guarantees can be provided for individual transactions that are large enough to justify the transaction costs. The most suitable form of guarantee enhancement for individual projects is the *PRG L/C structure* which can be designed to provide direct compensation to the project company for revenue shortfalls caused by government default on its contractual payment obligations. The compensation is made through draw-down of an L/C arranged by the government with a commercial bank in the name of the project company up to a pre-agreed amount. The guarantee could then be called if the government does not reimburse the commercial bank for the amount drawn from the L/C within a specific time period. By contrast, the *PRG limited recourse* structure would be less effective as it would mitigate government payment risk only for project lenders and not for equity providers. The *PCG* would not be applicable in this case as it is designed to backstop borrowings only by public and not by private entities.

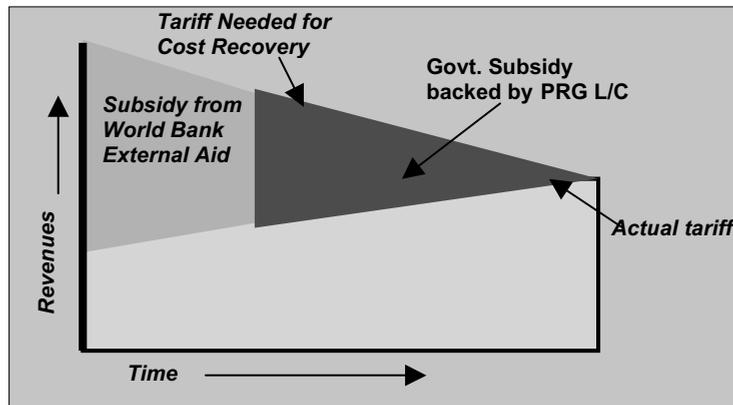
### 5.1 Enhancement of Transitional OBA Subsidies

Transitional subsidies are intended for situations in which a private operator assumes responsibility from a high-cost, and less efficient public service provider and where tariffs are highly subsidized. During the transitional period, the private operator will be required to increase efficiency and reduce costs. At the same time, service quality improvements will be achieved as a result of investments and better operating performance. This will increase consumers' willingness to pay, thus allowing the operator to increase tariffs. The desired result is a gradual rise in tariffs to a level that corresponds to the cost of efficient service provision, does not require any more subsidies, and is affordable to end-users.

Under a transitional subsidy, a guarantee could be provided for the entire transition period on the basis of the L/C structure described above. Since in this case the periodic subsidy requirement would decline over time, the maximum guarantee cover needed would diminish correspondingly. Alternatively, the payment of the transitional subsidy could be financed for an initial period of up to five years from an IBRD Loan or an IDA Credit and/or other external assistance sources, to be substituted by direct government subsidies thereafter. For these later subsidy payments a PRG L/C structure could be arranged which, in combination with the initial subsidy funding, would enable successful contract negotiations and facilitate the mobilization of private investment financing. However, the proposed PRG L/C structure enhances only part of the revenue generation and debt service capacity of a project. It does not address other government performance risks, e.g. prevention of agreed tariff increases, which may require additional guarantee support, combined potentially with a government undertaking to compensate the project for the foregone revenues in order to maintain its debt service capacity. The proposed structure also does not address utility operational and market risks (e.g. consumer acceptance) which are typically risks to be assumed by the operator.

The structure described above is depicted in the chart below in which a declining subsidy (blue) is financed during the initial years from external assistance sources, followed by a period of further declining subsidy (red) financed from the government budget with external credit enhancement. The initial, highly subsidized tariff (green) is gradually raised until it reaches cost recovery level and the subsidy is phased out.

**Figure 1**  
Transitional Subsidy



## 5.2 Enhancement of Long-Term OBA Subsidies

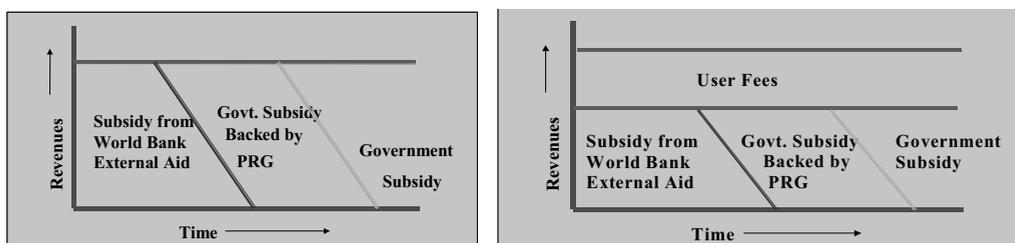
Long-term subsidies are intended for infrastructure services where full cost recovery is not justified in the foreseeable future for reasons of externalities or affordability (e.g. toll roads, water supply schemes, power distribution). Technically similar are long-term government payments, akin to subsidies, that provide the entire revenue source of service providers where levying of direct user fees is not feasible (e.g. in performance based road rehabilitation and maintenance schemes, shadow toll roads or health services based on voucher distribution to target groups).

In projects where the subsidy is of a long-term nature, the credit enhancement would need to be designed for a prolonged period of time. Similarly to the transitional case, the subsidy payment could initially be financed from external assistance, followed by credit-enhanced government budget payments, or credit enhancement could be provided from the beginning if direct foreign aid funding were not available. The appropriate form of guarantee would be the same PRG L/C structure as described above. The guarantee cover in this case would be uniform, i.e. not declining.

Over time the objective should be to establish reliability and creditworthiness of the government payment mechanism so that eventually the credit enhancement could completely fall away and government payments would be accepted by the service provider without risk mitigation. This sequencing of subsidy financing, enhancement and government payments without risk mitigation is depicted in the charts below. The first chart presents a project which depends entirely on official payments (e.g. a performance based road management scheme or shadow toll road), the second chart presents a project with revenues obtained from user fees and subsidies (e.g. a toll road or water supply system with partial cost coverage).

**Figure 2**

**Long-term Subsidy without user Fees      Long-term Subsidy with user Fees**



### 5.3 Blending of Instruments

"Hybrid" structures of OBA aid financing and credit enhancement, as presented in the sections above, could require processing and approval of a guarantee operation at the same time as the initial IBRD loan or IDA credit (or other external aid) financing. This might be necessary, if commercial funding for project investments is of longer tenor than the disbursement period for the initial World Bank or other external assistance funds, and private financiers want to be assured of the reliability of subsidy payments beyond the initial development agency funding period. This would add to the complexity of the transaction. A guarantee-only transaction would require government budget resources from the beginning. This would be a disadvantage particularly for IDA countries that have access to very inexpensive development assistance. But it could also be an incentive for good budget management and for rapid reduction of enshrined subsidy schemes. Moreover, guarantees now offer the advantage that they carry only 25% weight in a country's borrowing from IBRD or IDA (see footnote 3). Therefore it may be more attractive for a country to choose a guarantee-only solution right from the beginning.

In more complex risk situations, guarantees that backstop OBA payments could be combined with PRGs against government default on policy and regulatory undertakings (e.g. tariff increases under transitional subsidy schemes, see chapter 5.1.) and/or against political and other government performance risks. Such PRGs would provide risk mitigation against losses of project revenues from user fees.

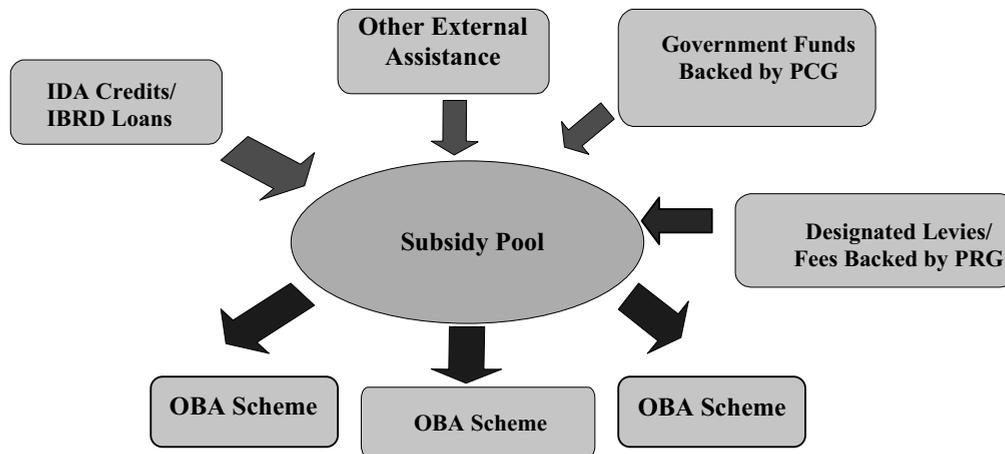
## 6. OBA CREDIT ENHANCEMENT THROUGH SUBSIDY POOLS

Under certain conditions, governments may wish to set up a subsidy pool to finance OBA payments. This could offer advantages when the intention is to secure funding for several or many projects, in particular those of smaller size. Such a structure could in particular reduce transaction costs for individual projects and financing costs for the pool. This facility could initially be co-financed through IBRD loans/IDA credits, other external aid funds and government's own resources. For its contribution, the government could utilize a World Bank partial credit guarantee to raise private funding from capital or loan markets which could help extend the term and lower the cost of borrowings.

The OBA subsidy pool could facilitate the provision of transitional and long-term subsidies under various OBA schemes in different sectors, but would be particularly relevant for the funding of long-term OBA schemes with continuing small investments such as new telephone, power or water connections in rural areas. Under such schemes small amounts of subsidy payments are required for longer periods to fund ongoing support to targeted categories of consumers.

Even though the funding of the pool would be (at least initially) principally from direct external assistance sources, government contributions based on guarantee-supported borrowing from financial markets would allow the pool to finance streams of subsidy payments beyond the customary disbursement periods of the aid agencies. These contributions could later be supplemented and eventually replaced by an increasing share of financing from sector levies and user charges from existing operations, or other governmental revenue sources including taxes.

**Figure 3**  
Pooled Subsidy Credit Enhancement



This structure could be complemented by a World Bank PRG designed to backstop government commitments relating to the transfer of funds into the pool. Once the pool has a track record of being successfully managed and has a steady source of funding from sector levies, fees and taxes, underpinning of government commitments may not be required any longer and the credit enhancement could fall away.

## 7. PROCUREMENT AND DISBURSEMENT UNDER OBA GUARANTEES

Procurement and disbursement under OBA guarantees will broadly be consistent with the approaches that are being proposed for direct IBRD and IDA financing of OBA schemes. However, the principal difference, and facilitating factor is that procurement will fall under the rules for loans guaranteed (and not financed) by the Bank. These do not imply the use of speci-

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fic procurement methods, but stipulate that goods and works shall be procured with due attention to economy and efficiency and in accordance with basic quality, price and delivery requirements. If the OBA-supported project is competitively bid, the economy and efficiency principles will generally be considered fulfilled regardless of the procurement methods applied by the private operator. If the OBA supports a project carried out by an incumbent private operator, the Bank will carry out an assessment of the operator's procurement methods to determine whether they correspond to the basic economy and efficiency principles or whether any modifications would be warranted.

Disbursements under OBA guarantees will not be subject to the World Bank's disbursement procedures as they will be governed by the rules applying to payments from the respective governments' budgets. However, the contractual links between the OBA payments, the delivery of services, and the amount guaranteed have to be clearly established and sound financial management principles will have to be followed to permit verification of financial statements for the project.

## ANNEX 1

### World Bank Guarantees - Fee Structure

The transaction costs for guarantee operations are aligned with the basic fee structure for IBRD loans and IDA credits, but include up-front fees which are more typical of private sector lending and borrowing operations. The three fee categories associated with guarantees are:

- *Standby Fee:* For IDA Guarantees, the Bank will charge a standby fee of 25 bp p.a. and for IBRD Guarantees 75 bp p.a. per annum on the guaranteed amount to the borrower. If the guarantee expires without being called, the standby fee (together with all investment income earned thereon) is passed on to the government, except that the Bank retains 25 bp p.a. for IBRD Guarantees.
- *Guarantee Fee:* A guarantee fee is charged on the maximum amount of guaranteed debt during an interest period. IDA charges a minimum guarantee fee of 75 bp p.a., equal to the service charge on IDA credits, of which it retains the full amount. The fee charged on IBRD guarantees amounts to 100 bp p.a., of which the Bank retains 50 bp p.a..
- *Other Fees:* Both for IDA and for IBRD Guarantees, the Bank charges the borrower a one-time initiation fee of 15 bp p.a. of the total guaranteed debt or US \$100,000 (whichever is higher), payable as a condition of guarantee effectiveness. In addition the borrower has to pay a processing fee of up to 50 bp p.a. of the total guaranteed debt, and, for IBRD guarantees, a front-end fee of 100 bp p.a. on the maximum guaranteed principal.

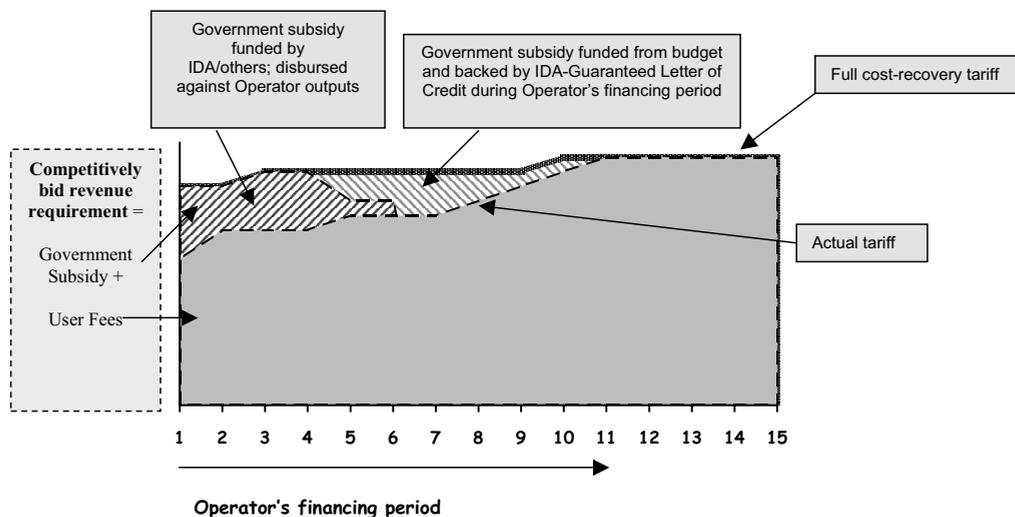
## ANNEX 2

### OBA Credit Enhancement - A Hypothetical Example

How can the Operator of the Country X Water Concession be induced to start an OBA scheme for providing water connections in a town with a population of 1 million poor inhabitants?

- Create sufficient 'revenue security' for Operator to raise significant capital for the desired long-term asset investment program.
- Induce Government to take responsibility over time for budgeting of any required subsidy.
- Make the regulator responsible for balancing rates for water consumers against Government subsidy.

In the example the private operator is willing to service the households provided it can charge an average tariff of \$.70 per cubic meter (A financially viable tariff for the operator). Service improvements will be made and investments will be financed from commercial loans mobilized by the Operator. The poor households, in this case, cannot afford, and are not willing to pay more than \$.45 per cubic meter initially. Their willingness and ability to pay is assumed to increase over time, as the Operator improves service provision. The initial gap of \$.25 per cubic meter in the tariff as discussed earlier and illustrated in the following figure, could over a first period be financed through either an IDA Credit or Grant. However once development assistance comes to an end, the government would have to fund the gap from budget resources.



The IDA Credit or Grant lasts for 6 years in this case. After the 6 year period, the consumers are willing to pay \$.55 per cubic meter. The gap of \$.15 will be provided by the government from budget resources and will be backed by an IDA Partial Risk Guarantee (Letter of credit structure). After a further 5 year period, the subsidy will be phased out and consumer will pay full cost-recovery tariffs to the Operator.

To take the example further, let us assume that the households average consumption per household is 20 cubic meter and therefore the total household bill for the town would be around \$14 million (20\* .70\* 1 million) per year.

At the beginning of year 7, the Government is subsidizing 21% of the tariff which is around \$3 million. The Guarantee would cover \$3 million initially and then would taper-off as subsidies

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would be reduced and consumer tariffs would be adjusted to approach full cost-recovery tariffs. If the guarantee is called, the government would be liable pay the amount to the L/C bank in the stipulated time period. If it fails to do so, IDA pays to the L/C bank and will be reimbursed by the Government under the indemnity agreement.

Technical aspects of the IDA-Guaranteed Letter of Credit scheme

- The Government would arrange a 'standby letter of credit' (L/C) from a commercial bank (L/C Bank) in the amount of, say, a year's Government's subsidy.
  - the letter of credit should be competitively arranged considering the IDA Guarantee
  - the Government would be required to repay the L/C Bank on normal commercial terms, say, within 6 months or 1 year
- The Operator would be entitled to draw on the L/C if the Government fails to make a Government subsidy payment.
- IDA would guarantee repayment to the L/C Bank of draws by the Operator, at stipulated repayment dates.