When governments turn to private operators to provide infrastructure services, the reason often is to tap private sources of finance. To obtain market financing for an infrastructure project, however, a private operator needs to be able to provide potential investors assurance that revenue flows to the project will be reliable. Where those revenue flows consist in part of government output-based aid (OBA) subsidy payments, providing that assurance can be problematic. Many governments are considered unreliable payers and therefore assigned a low credit rating by financial markets and investors. In these cases the credit quality of OBA payments needs to be enhanced if they are to help attract investment financing to the project. The World Bank offers guarantee instruments that can enhance the creditworthiness of such payments. There are two main options: partial risk guarantees to mitigate the risk of a government failing to make OBA payments for individual projects, and partial credit guarantees to help governments raise financing for a subsidy pool providing OBA payments to multiple projects.

Governments entrust infrastructure service provision to a private operator often because they wish to tap commercial financing without affecting their budget, particularly important when big up-front investments are needed. But attracting market financing for private infrastructure investments requires a dependable, creditworthy revenue stream that will cover the full cost of service provision (operational expenses, debt service) plus a reasonable return to shareholders.

Where revenues consist entirely of user fees, an investor’s decision to provide financing will depend largely on its assessment of such factors as the customer base, payment discipline, collection efficiency, and billing system. In some projects, however, revenues may also include government subsidies if user tariffs cannot be set high enough to recover full costs—because users are either unable or unwilling to pay such tariffs. In these cases investors will assess the combined risk of the two types of cash flow.

The subsidy can be structured in two broadly different ways. In the first the government provides an initial capital grant during the main investment phase, typically the first few years. This grant reduces the initial project financing requirements and thus the revenues (and user fees) needed to recover full costs.

In the second the initial project financing comes entirely from private sources, leading to a need for higher project revenues to recover costs. Here the government needs to provide periodic subsidies after the initial investment phase to keep user fees affordable. Governments and aid agencies increasingly prefer this approach for infrastructure service provision because periodic subsidies structured in the right way, as output-based aid (OBA) payments, offer a much better tool for introducing performance incentives, accountability, and targeting.

Nevertheless, subsidies structured as OBA payments raise challenges for project finance. Because they form part of a project’s future cash flow, they need to meet standards of creditworthiness high enough to mobilize commercial financing. But many governments are considered not creditworthy, earning a low credit rating from financial markets and investors. In these cases the credit quality of government subsidies needs to be enhanced.

\footnote{OBA payments are targeted, performance-based subsidies used when recovering full costs through direct user fees is not justified, not possible, or not practical.}
Using direct aid agency financing

One way to enhance the creditworthiness of OBA payments is to rely on development assistance to finance the subsidies. The credit rating and credibility of development agencies can lend a high level of creditworthiness as long as the disbursement mechanisms ensure a payment stream that is in accordance with the stipulations in the operating contract.\(^2\)

But financing subsidies from development assistance often will not be possible. The World Bank and other aid agencies normally will not commit to indefinite support of a subsidy scheme, but instead expect subsidy payments to be phased out (the transition model) or sustained after a time through the domestic budget (the long-term subsidy model). Even under the transition model aid resources may not be available for the entire transition period if it exceeds the project implementation periods to which aid agencies normally commit (for the World Bank, around five to six years). Moreover, governments may not wish to borrow for subsidy payments, and agencies’ country programs may lack the resources for that purpose.

Relying on World Bank guarantees

Where OBA payments need to be financed directly from government budgets, their credit quality can be raised through guarantees by the World Bank. Developed to help mobilize commercial financing for private investment projects or for public funding, World Bank guarantees mitigate the risk of a government failing to meet its contractual obligations. The World Bank’s unique relationship with its member countries and their governments puts it in a good position to backstop certain government obligations. A World Bank guarantee, coupled with the mandatory government counter-guarantee, can raise the creditworthiness of an OBA scheme because it reinforces the incentives for the government to comply with its contractual obligation to pay the subsidies. The World Bank offers two kinds of guarantees that could be used to enhance OBA structures.

Partial risk guarantees ensure debt service payments by a private company in default as a result of a government’s failure to meet its contractual obligations. These guarantees can be arranged for borrowers eligible for International Bank for Reconstruction and Development (IBRD) loans as well as those eligible for International Development Association (IDA) credits. Two structures for partial risk guarantees have been developed, suitable for different types of transactions:

- The limited recourse structure guarantees commercial debt or shareholder loans to a private company and is particularly suited to project finance transactions.
- The letter of credit structure protects a private company against cash flow shortfalls caused by a government’s default on its contractual commitments. It is particularly suited to smaller privatization transactions.

Partial credit guarantees cover private lenders against all risks during a specified period of the financing term or for a specified part of the debt. They are designed to extend and improve terms for market borrowing by public entities. These guarantees are not available in IDA countries, but could be used to enhance OBA credit in an IBRD country if the government or a government entity borrows from financial markets to finance OBA payments. But since governments are unlikely to take on debt simply to finance subsidies for an individual project, partial credit guarantees will probably be used only for subsidy pools for multiple projects.

Enhancing credit for individual projects

World Bank guarantees can be provided for individual OBA projects large enough to justify the transaction costs. Guarantees for OBA schemes need to backstop as directly as possible the government subsidy payments to the project company, to increase the perceived reliability and creditworthiness of its revenue stream. Most suitable for individual projects is the partial risk guarantee under the letter of credit structure, which allows direct compensation of the project company for revenue shortfalls caused by government default. Compensation is paid to the project company through a letter of credit arranged by the government with a commercial bank. If the government fails to reimburse the bank for the amount drawn from the letter of credit within a specified period, the World Bank would do so.

But the letter of credit structure protects a project against only one kind of risk—government nonpayment— to its ability to generate revenue and service debt. It does not address other risks relating to government performance. Where risks are complex, guarantees that backstop OBA payments could be combined with partial risk guarantees.

\(^2\) The World Bank is attempting to mainstream OBA payments from aid resources. Similarly, GPOBA recently introduced a window to finance OBA payments.
guarantees against government default on policy and regulatory undertakings (such as tariff increases) or against political and other government performance risks. These partial risk guarantees would reduce the risk of loss of revenues from user fees. The guarantee structure does not address operational and market risks (such as consumer acceptance), typically assumed by the operator.

The limited recourse structure would be less effective, since it would reduce the risk of government nonpayment only for project lenders, not equity providers. And the partial credit guarantee could not be used in this case because it is designed to backstop borrowing only by public entities, not private ones.

**Enhancing transitional subsidies**

Transitional subsidies are used where a private operator takes over from a high-cost, inefficient public service provider and tariffs are heavily subsidized. During the transition period the private operator is required to increase efficiency and reduce costs. Meanwhile investments and better operating performance improve service quality, increasing consumers’ willingness to pay and thus allowing the operator to raise tariffs, eventually to a level that ends the need for subsidies.

A guarantee could be provided for the entire transition period under the letter of credit structure. Since the periodic subsidies needed would decline over time, the guarantee cover can decline accordingly. Alternatively, the transitional subsidies could initially be financed, say for up to five years, from an IBRD loan, an IDA credit, or other external assistance, then paid directly by the government, with these later subsidy payments covered by a partial risk guarantee under a letter of credit structure. Combined with the initial financing of the subsidy, the guarantee would help attract private financing.

**Enhancing long-term subsidies**

Long-term subsidies are intended for infrastructure services which full cost recovery is not justified in the foreseeable future because of externalities or because users could not afford tariffs that cover the cost (toll roads, water supply, power distribution). Technically similar are long-term government payments that provide the entire revenue stream for projects where levying direct user fees would be infeasible (voucher-based health services, performance-based road rehabilitation and maintenance).

Where subsidies are long term, the credit enhancement would also have to be long term. Just as for transitional subsidies, initially the payments could be financed from external assistance, followed by credit-enhanced government budget payments—or credit enhancement could be provided from the beginning. And again a partial risk guarantee under a letter of credit structure would be appropriate choice. But here the guarantee cover would be uniform, not declining.

Over time the aim should be to establish the reliability and creditworthiness of the government payments so that the credit enhancement can eventually fall away.

**Blending instruments**

Where hybrid structures are used, combining aid financing and credit enhancement for OBA subsidies, the guarantee may need to be approved at the same time as the initial IBRD loan or IDA credit (or other external aid). This might be necessary, for example, if commercial investment financing for a project has a term longer than the disbursement period for the initial external assistance and private financiers want assurance of the reliability of subsidy payments that extends beyond that disbursement period. This requirement adds complexity to the transaction.

But a simpler transaction with only a guarantee would require government budget resources from the outset. This would be a disadvantage, particularly for IDA countries with access to inexpensive development assistance. Yet it
could also provide an incentive to manage budgets well and reduce subsidies rapidly. Moreover, guarantees now offer the advantage of carrying only 25 percent weight in a country’s borrowing from IBRD or IDA.\(^3\) So it may be more attractive for a country to choose a guarantee-only solution from the beginning.

**Enhancing credit for subsidy pools**

In some cases governments might want to set up a subsidy pool to finance OBA payments, such as when they plan to secure funding for several projects or for many, particularly small ones. A pool can reduce the transaction costs for each project as well as the overall financing costs. Initial financing could come from external assistance and the government’s own resources. For its contribution the government could use a partial credit guarantee to raise market financing, extending the term and lowering the cost of borrowing.

While a subsidy pool could provide transitional or long-term subsidies in a range of sectors, it is particularly suited to long-term OBA schemes with continuing small investments, such as new power, water, or telephone connections in rural areas. These schemes require small amounts of subsidy payments for long periods to fund ongoing support to targeted beneficiaries.

While the funding would at least initially come mainly from direct external assistance, government contributions based on guarantee-supported borrowing from financial markets would allow the pool to finance streams of subsidy payments beyond the aid agencies’ customary disbursement periods. These contributions could later be supplemented and eventually replaced by sector levies and user charges or by other government revenue, including taxes.

A partial risk guarantee could complement this structure by backstopping government commitments on transfers to the pool. Once the pool has a track record of sound management and steady funding from sector levies, fees, and taxes, government commitments may no longer need underpinning, and the credit enhancement could fall away.

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\(^3\) Thus a $100 million guarantee counts as only $25 million in a country’s lending program, leaving room for another $75 million in IBRD loans or IDA credits.