2014 Study on Development Assistance

Summary of "Study on the Blended Financing that Utilizes Grants and Loans in Japanese Official Development Assistance (ODA)"

1. Background and objectives of the study

In the light of increasingly limited donor countries' budgets for Official Development Assistance (ODA) and the global debate on how to increase the effectiveness of such aid and other related inputs for development, the European Union (EU) and a few other donor institutions have in recent years started "blended" financing programs which blend loans and grants for development purposes.

The aforementioned programs may provide grants to development projects in developing countries in order to increase their financial and project viability and make them "bankable"[1], with the expectation that this can encourage the provision of more financing for such countries from other financial or development institutions. At the same time, the Government of Japan is seeking to increase the development aid effectiveness of its limited ODA budget, and also increase the probability of Japanese companies in winning tenders in projects abroad that are financed by Yen Loans which are part of the Government of Japan's ODA scheme.

In consideration of the above, under this study, the facts and information on the current blended financing activities of other donor institutions including development finance institutions, and also on international rules governing such activities were collected, organized and objectively analyzed. Then, based on the study's findings, a proposal on improving the Government of Japan's ODA system in a way that increases the probability of Japanese companies in winning tenders in Yen Loan-finance projects abroad is provided.

2. Topics and methods of study

The study is broadly divided into the following topics: (1) review of blended financing facilities or programs of foreign donor institutions, (2) review of the international rules governing blended financing activities, (3) study on the domestic demand for blended financing in Japan, and (4) study on potential blended financing schemes under the

[1] A "bankable" project or proposal refers to having sufficient collateral, future cash flow and a high probability of success in order to be acceptable to institutional lenders for financing. See "Bankable: Definition", Business Dictionary, accessed February 18, 2015, http://www.businessdictionary.com/definition/bankable.html#ixzz3S3jFsgAD.

Government of Japan’s ODA system.

In this study, the blended financing facilities and programs of bilateral and multilateral donor institutions which are based in Western countries were reviewed. In particular, detailed information on the processes for selecting target projects to be financed by these blended financing facilities or programs were studied and collected. In regards to the review of international rules governing such activities, various relevant legal and regulatory frameworks of the Organization for Economic Co-operation and Development (OECD) and the OECD’s Development Assistance Committee (DAC) were looked at. Then, information on the domestic Japanese demand for blended financing that were obtained through interviews with Japanese companies and industry associations which are experienced in ODA-financed projects were studied and analyzed. Finally, based on the above study findings, potential blended financing schemes that can be introduced into the Government of Japan’s existing ODA system were studied.

3. Results of the study

(1) Review of blended financing facilities or programs of foreign donor institutions

In this review of blended financing facilities or programs of foreign donor institutions, 49 bilateral or multilateral donor institutions that are based primarily in Western countries were first scanned through reading academic and other literature and interviewing experts on a preliminary basis.

As a result of this review, the list of targets for study was narrowed down to 13 donor institutions and 30 blended financing programs, in which the layout of their blended financing systems was studied through sending out questionnaires to and interviewing with each organization’s blended financing facility or program representatives, as well as through further literature review.

Based on the above findings, blended financing activities could be separated into two categories, namely blended financing that is conducted directly by a donor institution, and one that is funded by a donor institution and implemented through another donor institution. 13 organizations that belong to the first category were identified, namely the multilateral donor institutions of the EU, the Asian Development Bank (ADB), the World Bank and the Inter-American Development Bank (IADB), as well as the bilateral donor institutions of the Germany’s Kreditanstalt für Wiederaufbau (KfW), Denmark’s Danish International Development Agency (DANIDA), Belgium’s Belgian Investment Company for Developing Countries (BIO), the Netherlands’ Netherlands Enterprise Agency or Rijksdienst voor Ondernemend Nederland (RVO) and Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO), Australia’s

Department of Foreign Affairs and Trade (DFAT), Canada's Department of Foreign Affairs, Trade and Development (DFATD) and the US' United States Agency for International Development (USAID) and Millennium Challenge Corporation (MCC).

Finally, as case studies, four programs from the aforementioned 30 programs of 13 donor institutions that are believed to be able provide important best practices of blended financing which can be introduced into the Government of Japan's ODA system were probed into. In particular, the said four programs' processes of selecting target projects for blended financing were studied. A summary of the case studies are as follows.

i. EU – Western Balkans Investment Framework (WBIF)

The WBIF supports socio-economic development and EU accession across the Western Balkans through the provision of grants and loans for projects in that region. WBIF's grants come in the form of direct investment grants, risk capital, interest rate subsidies and insurance premia subsidies. While WBIF's methodology for deciding the grant amount and therefore the grant proportion in relation to the entire financing package is not publicly available, it can be inferred from academic literature, the donor's documents and other materials as well as interviews with the donor institution's representatives that the grant proportion is calculated based on the project's financial viability and profitability.

ii. ADB – Asian Development Fund (ADF)

The ADF is a fund that is operated by the ADB, and is a source of concessionary financing that is dedicated to the development needs of the Asian region. The ADF provides loans on concessional terms and grants to ADB's developing member countries (DMCs) that have low incomes per capita and limited or low creditworthiness. The proportion of the ADF's grants and loans in its financing packages is determined by the recipient country's debt-distress classification.

iii. DANIDA – DANIDA Business Finance (DBF)

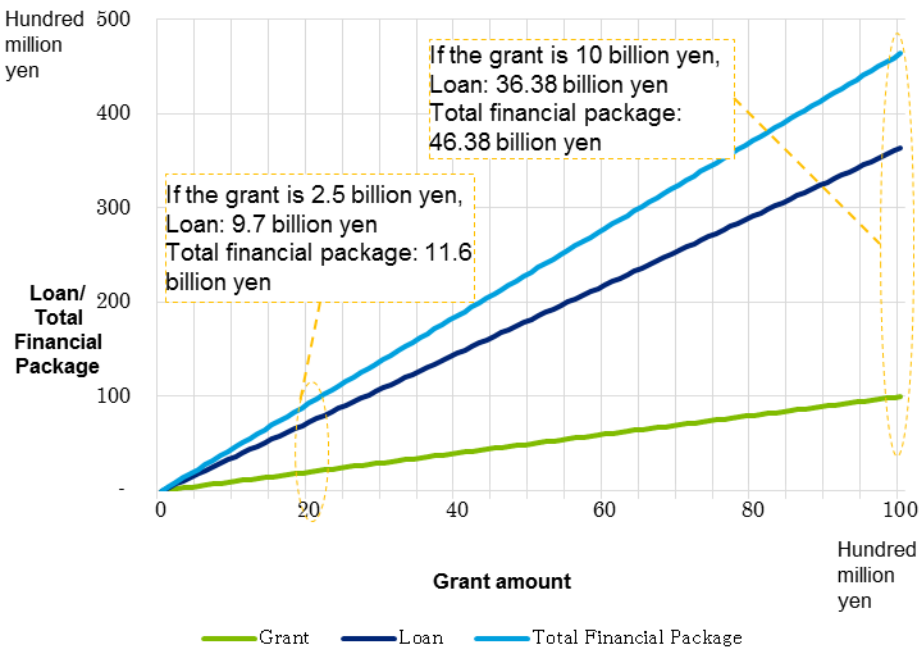
The DBF is a blended financing framework wherein DANIDA provides grants to Danish financial institutions, which in turn provide concessional loans that are subsidized by DANIDA's grants. DBF's concession loans are aimed at ensuring financing for large-scale public infrastructure projects that would and could not be financed on market terms. DANIDA's grants to the Danish financial institutions come in the forms of full or partial payment of interest, payment of bank margins, payment of export credit premia and other financial costs, and cash grant to reduce the principal of the loan if the aforementioned grants do not amount to the subsidy level required by the ruling OECD agreement. The DBF has a tied aid facility whereby the supplier has to be a Danish company, and this facility is subject to international rules on tied aid which are explained further below in the summary.

iv. Millennium Challenge Corporation (MCC)

The MCC is a US government foreign aid agency which provides grants to developing countries that fulfill various requirements relating to good policies and governance, among others. The MCC provides grants for a variety of types of projects, covering project development and implementation. The modalities of its grants have included viability gap funding (VGF), grants for commercial loans from banks in projects, and challenge grants, among others.

(2) Review of the international rules related governing blended financing activities

According to the relevant international rules and the Helsinki Package of the Arrangement on Officially Supported Export Credits (“Helsinki Package”) in particular, blended financing as part of ODA can only be provided to projects that are not commercially viable and also contribute to development. Further, when blended financing is provided as tied aid by the Government of Japan, the recipient of such blended financing is limited to low- and middle-income countries, as defined by the World Bank based on Gross National Income (GNI) per capita. Also, if a blended financing package does not meet the concessionality level (C/L) requirements as provided for under the Helsinki Package, the provision of such financing will either be disallowed, or require prior notification to the OECD. When the aforementioned points are considered, for example, if the grant amount of a blended financing package is around 500 million yen, the required total amount of the package (including the loan portion) will have to be at least approximately 1.8 billion yen. However, if the grant amount of a blended financing package is around 10 billion yen, the required total amount of the package (including the loan portion) will have to be at least approximately 46.3 billion yen



(3) Study on the domestic demand for blended financing in Japan

A number of feedback from interviews with Japanese companies which are experienced with Japanese ODA-financed projects abroad were obtained, and these feedback can be categorized under "effectiveness of blended financing systems", "form of blended financing systems", and "building an environment for blended financing systems".

In regards to "effectiveness of blended financing systems", the Japanese companies that were interviewed expressed a desire to have a system whereby the Government of Japan's blended financing is in the form of tied aid where the supplier and/ or goods and services content have to be of Japanese origin and implemented either under contracts or as a matter of practice. In regards to the "form of blended financing systems", the companies expressed a desire to have two types of blended financing, namely blended financing packages that mix loans and grants, and VGF grants. Further, in regards to "building an environment for blended financing systems", the companies expressed a desire to have an environment where various blended financing-related procedures are integrated into a single process, and the risk allocation is made clear.

(4) Study on potential blended financing schemes under the Government of Japan's ODA system

i. Deciding on the necessary conditions for selecting target projects for blended financing

The two conditions that are necessary to be fulfilled in order to select a recipient country for blended financing are the “appropriateness of aid” and “commercial viability”. The condition of “appropriateness of aid” may include indicators such as the applicability of the aid to the donor country’s ODA policy and the recipient country’s development needs, or the possibility of making the said aid a tied aid, for example. Meanwhile, the condition of “commercial viability” may include indicators such as the inability of a project to repay its debts within a certain time period after the start of the project under usual commercial financing rates.

ii. Preparatory survey

The preparatory survey is the Japan International Cooperation Agency’s (JICA) feasibility study process that is conducted before deciding to extend grant aid. Due to the novel nature of blended financing in the context of Japan’s ODA system, it may be necessary to add information such as those on the results of market sounding in regards to the target project, the financing environment, the required grant amount, project risk allocation and draft tender documents, among others to the current form of the preparatory survey. Also, one method in calculating the required grant amount is to quantify the financing gap of a project through calculating the project net present value (NPV).

iii. Conclusion of the Exchange of Notes (E/N), the Loan Agreement (L/A) and the Grant Agreement (G/A)

In accordance to the practice of several foreign donor institutions, blended financing packages can be decided through an agreement between the donor institution and the recipient country’s government. In regards to the agreement process, firstly, the donor institution and the recipient country’s government conclude an arrangement such as an E/N whereby the basic principles and policies of the financing package that blends grants and loans are listed in an integrated manner, and subsequently under such an agreement, both sides separately conclude G/A and L/A. As the proposed blended financing scheme includes providing such financing to project special purpose companies (SPCs) through the recipient government which has territorial jurisdiction over the project, there is a need to add the said indirect blended financing methods, terms and conditions to the existing clauses within the E/N.

iv. Provision/ procurement of financing

There are two patterns of provision or procurement of blended financing after the conclusion of the E/N, the L/A and the G/A, as below. The below figures illustrate the process flow of the said patterns.

A) When providing blended financing to Engineering, Procurement and Construction (EPC) and Operations and Maintenance (O&M) project phases separately

Decide on providing blended financing	• JICA provides blended financing to the recipient government. • JICA imposes tied aid conditions on the EPC contractor.
Conclude E/N, L/A and G/A	• The relevant project stakeholders conclude an E/N which lists their rights and obligations from the EPC stage to the O&M stage that is under the recipient government's responsibility, and under that the L/A and the G/A are concluded separately.
Tender out construction work for ODA-financed projects	• The recipient country government tenders construction work for ODA-financed projects in its territory. • JICA allocates blended funds in payments to EPC contractors.
Select O&M contractor for PPP projects	• The recipient country government tenders O&M work in completed projects under a Public-Private Partnership (PPP) framework.
Rent out project facilities to O&M contractor	• The recipient government rents out project facilities to the selected O&M contractor. • The recipient government uses the collected rent obtained from renting out the said facilities to repay its loans.

B) When providing blended financing to both Engineering, Procurement and Construction (EPC) and Operations and Maintenance (O&M) project phases in an integrated manner

Decide on providing blended financing	• JICA provides blended financing to the recipient government. • JICA imposes tied aid conditions on the EPC and O&M contractors.
Conclude E/N, L/A and G/A	• The relevant project stakeholders conclude an E/N which states that project work from the EPC to the O&M stages are to be tendered to external contractors, but the recipient government remains responsible for O&M. Under that, the L/A and G/A are concluded separately.
Select consortium for PPP project	• Tender Public-Private Partnership (PPP) project as a package which includes work from the construction phase to the O&M phase. • Select the consortium which comprises representative Japanese companies.
Allocation of capital from recipient country government	• The recipient government allocates the blended funds that are received from the Japanese government to the project SPC in the forms of equity, loans and subsidies, and then the SPC tenders out EPC work.
Transfer ownership of facilities	• Upon the completion of the EPC, the recipient government transfers ownership of the project facilities (only in the form of BTO).
SPC operates project	• The project SPC selects the O&M contractor, and assumes responsibility for project operations. • The recipient government uses dividends obtained from the SPC to repay its loans.

v. Deciding on the order of priority of multiple target projects for blended financing

When a donor institution receives multiple applications for its blended financing within the same time period, there will have to be a few indicators or thresholds for creating an order of priority of the target projects for such financing. The indicators or thresholds can include the order of priority of the recipient countries, the possibility of utilizing technology from Japanese companies in target projects, the degree of reduction of risk for participating Japanese companies in the target projects, the aid activities of other donor institutions, and the necessity for blended financing that utilizes grants and loans rather than just standalone grant or loan aid, among others.