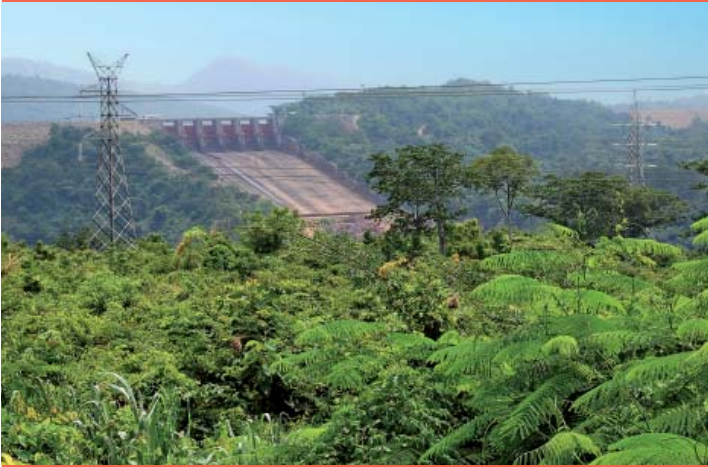


# NEW MODELS FOR FINANCING ESSENTIAL SERVICES

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Jean-Michel Severino has spent his entire career in international development and its financing. He was previously Vice-President for East Asia at the World Bank (1996-2000) and Executive Director of AFD, the French Development Agency, from 2001 to 2010. Since 2011 he has been CEO of Investisseurs & Partenaires (I&P), an impact investing fund dedicated to supporting small and medium-size businesses in sub-Saharan Africa. He is a member of several investment committees and boards of funds allied with I&P (Phitrust Partenaires, Adenia Partners and Grameen Crédit Agricole) as well as several major corporates (Orange SA, Danone and Michelin).

In recent years, states across the African continent have increased their investments in the water, sanitation and energy sectors. However, the extent of the infrastructure remains well below the global average, and population growth in Africa will intensify demand for basic services. The question of financing these services – capital-intensive at first and only generating a return in the long term – is strategically important. With the emergence of decentralized systems, primarily in the energy sector, private actors such as businesses, foundations, impact investment funds, etc., have increasingly financed infrastructures that are alternatives and/or complementary to centralized services. Although a driver for progress and innovation, private financing can never fully meet the vast need for financing. It cannot replace public financing, particularly in low-profitability regions where households lack the means to pay for services and equipment. New mindsets and new forms of (de) regulation are needed to bring together all actors, public and private, international and domestic, to find ways to finance these services.

## What have been the main sources of finance for water, sanitation and energy services in Africa in recent years?

Jean-Michel Severino: Quantitatively, in recent years state financing has been the most common instrument for financing water, sanitation and energy services. We are in a period where, until the coronavirus crisis struck, state budgets had risen considerably on the back of Africa's economic growth since the turn of the century. States were in a position to allocate major sums to building up their infrastructures, particularly in the water sector. Sadly, these sums remain insufficient to close the gap in terms of facilities available to African populations.

A not-inconsiderable portion of investments made by the poorest states was financed through public development aid in the form of donations, whereas states with sounder economies were able to either borrow from major multilateral and bilateral financial institutions or directly on international capital markets. Against this background, China has made a considerable contribution to financing, particularly major centralized energy installations. This is one of the main reasons for the explosion of the African sovereign debt over the past decade.

At the same time, although some major public-private partnership operations have been put in place, those were less common in the water and waste sectors than in energy and transportation.

The crucial innovation has been the rise of decentralized systems, notably in the energy sector. In energy, the overwhelming majority of financing was provided by private investors, whether from risk capital investment funds, foundations or even NGOs for the least profitable propositions. A major innovation saw for-profit and non-profit private capital join forces to develop decentralized markets. In the energy sector we have seen impact investors from Europe and the USA combining with major multinationals, working via their foundations or dedicated innovation programs and funds. This was especially prevalent in East Africa: the combination of good cellphone coverage and very dynamic actors on the ground genuinely transformed the situation in rural areas. This accounts for millions of rural households with access to energy thanks to decentralized systems, rolled out with very little in the way of public capital or subsidy.

*A major innovation saw for-profit and non-profit private capital join forces to develop decentralized markets*

## You stress the growing role of private investment in the financing of essential services. Is there not a risk that private investors will only finance the most profitable services?

JMS: There is no doubt that there are two major limitations to the expansion of decentralized services and the growth in private financing.

The first limitation centers on serving the least well-off and least densely populated rural areas, places where it is very hard to run a profitable service. In these areas, state intervention in the form of subsidies is often indispensable, boosting the purchasing power of households that are generally very far from being able to afford basic equipment without assistance.

The second limitation is sectoral. If the energy and, to a lesser extent, waste sectors have witnessed the arrival of significant private investments, the water industry remains largely untouched by this process. Water is a highly capital-

intensive industry that is institutionally very much dominated by public monopolies, including in rural areas. The presence of public actors, be these domestic or international, is also a very long-established tradition that has made it quite hard for new private initiatives to emerge. As a rule, the creditworthiness of the water sector remains far more challenging, and this applies to drinking

water as much as sanitation. Decentralized solutions are currently being tested in various places around the world, but they remain small scale and the viability of their economic models, when applied to Africa, remains unproven, although this is not to say they are definitely unfeasible.

Although a diversification of financing sources is desirable, nothing can replace taxation, which is a wellspring for subsidies and the allocation of public funds, in order to finance activities that cannot be financed by the private sector. For several decades to come, in many parts of Africa we are going to keep relying on a combination of public financing, from state budgets, and national operators able to work with public mandates to reach out to the poorest members of society and to sectors of the economy unable to attain financial equilibrium. States also have key roles to play as regulators. Take decentralized energy as an example. As soon as fixed tariffs are imposed, there has to be very close consultation between regulators, or the energy ministry if there is no independent regulator, and private actors in the field so that the correct balance can be found.



## As CEO of a social impact investment fund, what is your approach to financing essential services?

**JMS:** First we need a bit of background. Essential services assets, energy assets in particular, have quickly become pretty expensive thanks to an influx of international risk capital, predominantly from the USA.

Investisseurs & Partenaires is a generalist investment fund that has already provided capital financing for several decentralized energy operations in poor countries such as Mauritania, Ghana, and across the Sahel region. The main criteria we use when selecting investments is a viable economic model combined with major impacts for the project's stakeholders. We always start by looking at impacts when assessing the relevance and eligibility of an investment, but we also look very closely at the conditions needed for profitability. This is because in recent years we have seen a lot of financially unsustainable projects rolled out in the essential services sector. This ultimately leads to failure and the disappearance of the impact hoped for. Venture capital approaches closely inspired by the digital economy often dominated: valuations were initially made on the basis of the number of connections or the speed that service points were rolled out, but without ever taking questions of financial equilibrium into account.

The conditions needed to attain profitability inevitably raise the issue of accessibility. If products are developed that are structurally too expensive, people will be unable to afford them. When looking at how business models are constructed, the two components we keep a constant watch on are households' ability to pay and the product's profitability.

Here I want to mention two examples from among the companies I&P has invested in, companies that offer valuable lessons for the sector.

The first is PEG Africa, a company we supported almost from the beginning. During our time working with the company we came to understand just how complicated it is to run a profitable access-to-energy service if you rely only on selling energy. It became clear that energy access had to be bundled with other products, such as audio, video and internet television services. The PEG story is a remarkable one, demonstrating the viability of its business model and proving itself able to control the multiple aspects of what is a highly complex industry. PEG is now selling beyond Ghana, in Côte d'Ivoire, Senegal and other countries in the region.

The second project that comes to mind is CDS, a company offering water and electricity services in rural areas of Mauritania. The project was originally conceived by an

NGO that then turned into a company. The approach, which combines both sectors by offering energy services and services for managing access to water (pumps, wells, etc.), turned out to be very efficient and effective because it bundles several products in regions where people have extremely limited spending capacity. The company used to offer carbon-fueled services but has transitioned to green energy, switching its sites from diesel generators to solar power. We ended up selling our stakes to Engie Rassembleur d'Énergie and SADEV, the impact fund of the government of Monaco.

### Do you think that Africa will inexorably shift away from the all-grid model?

JMS: I don't think we will see a complete reversal any time soon. To start with, countries with geothermal or hydroelectric power capacities – classed as green and renewable – have access to systems that are extremely efficient and cost very little, but necessarily involve centralized management. These management modes are well suited to supplying cities and major industrial sites. But it is equally possible that the share in the overall mix serviced by decentralized systems will end up being considerably higher in Africa than currently in industrialized economies. This is because of the vast extent of rural zones and the inadequacies of centralized systems, which mean that many people at present are forced to use diesel generators. And decentralized services provide valuable back-up services, including to areas connected to centralized energy grids.

The spread of decentralized systems over the coming years will depend on factors as yet unknown to us. Technological considerations will have a lot to do with it. For example, will we have access to efficient battery storage systems? If the answer is yes, then decentralized solutions may well increase at a much faster rate than at present, since limited energy storage capacity is one of their main weaknesses. There are also institutional factors that are hard to predict. Will states accept their publicly owned national operators being side-stepped, as happened with cellphones? Will they allow monopolies to be broken up? Energy companies are powerful in Africa, and the establishment of major decentralized actors is not something that they will necessarily welcome with open arms.

Different scenarios are possible, making predictions difficult. It is, however, reasonable to suppose that decentralized solutions will play a far larger role in Africa than in Europe.

### What do you think are the most promising innovations in financing for Africa?

JMS: First of all, before even touching on financing, the question of the organization of Africa's essential services sectors is key. It would be good to see deregulation coupled with more effective regulatory oversight. Regulatory stability makes it far easier to raise financing, domestically as well as internationally.

This last point is essential. Regarding financing for decentralized water and energy, we are talking about a scale and size of investment that should enable investors from across the African continent to participate. The capital sums involved are lower than those needed for major dams or largescale wastewater treatment plants. The decentralized model offers the opportunity for making more modestly sized investments, which should allow national actors to get involved. These types of operations need to be supported to encourage African-based actors to engage with operations in the capitalistic and corporate economy. The greater the move towards major centralized infrastructure, the more likely that financing will come from international capital.

Another extremely positive institutional evolution would be for actors operating on an international scale to team up with national project leaders. This would allow highly detailed local expertise to team up with state-of-the-art knowledge from all corners of the continent, if not the entire planet.

Impact investment is also a worthwhile source of financing for essential services. Impact funds seek a long-term equilibrium, they factor in non-financial objectives and are equally at ease talking about public policy-making

as about financial returns. There is a real opportunity for highly productive alliances to be forged between impact investors, major international corporations and national governments.

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