TAF Window 3: Project Capital Grants
Policy and Procedures

1. VGF POLICY

1.1 Introduction

This is a statement of interim policy and procedures for the implementation of TAF's VGF programme.

1.2 Viability Gap Funding (VGF)

VGF reduces the upfront capital costs of pro-poor PPP projects by in most cases making a grant available at the time of financial close so it can be used during construction. The "gap" addressed by VGF is between project costs and expected project revenues, assuming affordable user tariffs or unitary payments by government. The intention is to make economically viable projects financially viable, while helping to mobilise private sector investment and ensuring that the private sector still shares in the risks of infrastructure delivery and operation.

1.3 VGF Disbursement

a) For projects involving <u>debt and equity</u> VGF grants are intended primarily to address affordability issues and therefore make projects bankable. These grants normally become available once equity subscriptions are made and then disbursed pro rata with debt draw-downs. In exceptional cases, where the capital grant needs to be integrated into the capital structure of the project in order to attract lenders, TAF would consider VGF disbursement prior to debt disbursements if such disbursement could be supported by enhanced due diligence and monitoring of project milestones

b) For <u>equity-only</u> projects VGF is not intended to share construction risk, but again to address affordability issues. So for these projects VGF normally becomes available when construction completion is certified. There may be circumstances with equity-only projects where VGF may follow staged equity disbursements, if these are linked to reliable project delivery milestones – the disbursement issue will be considered as part of the VGF grant appraisal process.

1.4 VGF Risks and Risk Management

The chief risk associated with VGF is that grants are disbursed, but final pro-poor outputs are not achieved (either because the project is not completed or fails to perform, which in turn could be the result of a number of factors such as failure of the contractor or operator, or the government failing to honour relevant obligations).

TAF manages the risks associated with the use of VGF funding in a variety of ways:

a) <u>Financial viability</u>. TAF VGF funding must be clearly justified on the grounds that it transforms an economically viable pro-poor project into a financially viable one by attracting the necessary investment at affordable costs. This justification must be tested via early stage project appraisals, including cost-benefit analysis and value-for-money assessments.

b) Pro-poor. Because VGF normally does not permit a direct link between the grant and affordable services for poor people, as OBA does, the adequacy of mechanisms for ensuring that poor people benefit from the use of VGF grants must be assessed as well. Pro-poor outputs can be required by the terms of PPP contracts (or the terms of financial closure where PPP contracts are not applicable) and enforced by regulators. Or where no such contract or regulator is likely to exist, pro-poor benefits can be ensured by the nature of the project itself (locus, sector, expected users). Early stage assessments need to confirm that these mechanisms and/or characteristics are in place and capable of working as anticipated.

c) Equity first, pari passu with debt. To help manage the risk that VGF grants might be made to non-viable projects, the money is not accessed, even after award, until the equity for the project is in place. The logic of this is that equity investors will not contribute equity unless they are fully convinced of project viability, so this co-investment tends to confirm that the risks of project failure are minimal. Furthermore, for projects that are also funded with debt, VGF disbursement will usually take place pari passu with debt disbursements, therefore the disbursement of VGF can benefit from lender due diligence of project viability and monitoring of construction milestones (as well as due diligence by the equity investors). Under exceptional circumstances, as noted above in Sect. 1.3, VGF disbursements may be made prior to debt disbursements, but in any event only after the equity is in place.

d) In case of early termination. In the event of non-performance of the concessionaire or contractors and there being a performance guarantee in place, then on a project-by-project basis TAF may make it a condition that the proceeds of the guarantee are used to reimburse any VGF payments on the basis that VGF is in effect a payment in advance for services that have not been delivered. Similarly, in the event that any compensation is due to the concessionaire on termination as a result of government default, so total or partial repayment of the VGF grant would be made on the basis that the equity is also compensated for lost equity return.

e) Grant size limits. VGF should not comprise more than 15% of the capital costs of a project (or US$3 million per project, whichever is less) to ensure that private capital is genuinely at risk to performance and has ‘skin in the game’ to ensure project success. Proposals to exceed this 15% (or US$3 million) limit will be subject to special no-objection.

f) Competitive processes to determine grant size. One of the more tested ways of ensuring maximum value for money in the allocation of VGF grants is to link the determination of grant level to a competitive process for selecting private sponsors/operators (operators selected on the basis of lowest grant required). TAF will provide VGF support to projects that do not involve competitive selection of a sponsor/operator only under exceptional circumstances that will be assessed via a special no-objection review. Exceptional circumstances would include situations in which an operator/sponsor is already in place or has been established by the relevant PIDG facility as part of the project development process

g) When competition is not possible. When the determination of the grant level cannot be linked to the selection of a sponsor/operator through a competitive process, the recipient of the VGF grant is responsible for showing to the satisfaction of the PoE that the underlying project costs have been established through a competitive process or equivalent (i.e., are at a level that would have reasonably been achieved through competition, as determined through appropriate expert review and benchmarking), which in turn would impact the level of the VGF grant. This is to ensure that the VGF grant represents good value for money and does not excessively benefit the various project suppliers (of credit, equity investment, or construction/operation services). The assessment shall be designed to ensure the same grant outcome as that reached if the grant determination process were linked to competitive selection of the sponsor/operator.

1.5 The Role of TAF's PoE

In the case of TAF VGF grants, the various up-front appraisals and assessments must be carried out by the sponsoring PIDG facility and evaluated by TAF's Panel of Experts (PoE), a three-person committee with expertise in project finance, PPPs, infrastructure, public investment, and capital grants (a fourth member will be recruited to serve as back-up). The panel determines eligibility for VGF grants, and must also carefully assess the optimal size of grants, for reasons described above, including satisfying themselves about the process that has determined the proposed level of VGF. The PoE must approve an application for TAF VGF funding before it goes to PIDG donors for final approval.

1.6 Working with Public Procuring Authorities

Given that the case for allocating VGF support for a project is similar in effect to other forms of public sector investment decision making and implementation, there is the opportunity for the TAF to use its VGF decision making process to work with the relevant public procuring authority as it goes about making and implementing its own public investment decisions that may involve TAF VGF support, as well as with the relevant PIDG facility. By this means PIDG should be able to extract the additional benefits of improving the capacity of public procurement authorities.

2. VGF APPLICATION PREPARATION & APPROVAL

2.1 Availability of TAF Grants to Help with VGF Preparation

Small TAF grants are available to assist with the design of VGF programs and the preparation of application packages, including the detailed concept note required as part of each package. PIDG facilities should contact the TAF Technical Advisor regarding these grants.

2.2 Considerations Prior to Panel of Experts (PoE) Meeting

When TAF formally receives a project application and VGF Concept Note, the TAF Technical Advisor makes an initial assessment to ensure that the project is potentially eligible for TAF VGF funding.

2.3 Application Assessment by the PoE

The Technical Advisor circulates the VGF application package to the Panel of Experts, who have ten working days to assess the application package in terms of (i) eligibility, (ii) appropriateness of the size of the VGF grant requested, as well as (iii) the relative priority of the application, compared with other projects or with a predetermined reference base score set as a minimum by the PoE. In most cases, the project proponents will be asked to discuss their application and Concept Note with the PoE in a meeting or via a conference call. The PoE bases its judgment on the TAF VGF Eligibility Criteria and (if the project has been found to be eligible for VGF funding) the TAF VGF Evaluation Criteria, as well as a careful review of the business case for the project. The PoE members prepare short written reports expressing their views on the extent to which the application meets the TAF VGF Evaluation Criteria. The application may be rejected, it may be approved (or approved with specified modifications), or a final decision may be put on hold pending the submission and review of more information.

2.4 Role of the PoE in Projects for which VGF Size is Determined During Sponsor/Operator Selection

In cases where the size of the grant will be determined as part of the competitive process for selecting a sponsor/operator, the PoE will give preliminary approval to an estimate of the final grant amount, and the Window 3 donors will review the application on the same basis. If the present value of the VGF grant requested by the selected sponsor/operator is equal to or less than that estimated amount, the grant will be considered approved provided that the PoE are satisfied with the fairness and transparency of the competitive process. If the requested grant is higher than the estimated amount, it must be resubmitted for PoE and donor approval, with a written justification by the PIDG facility involved of the value for money of the level of VGF and confirmation that the total project costs estimated by the winning bidder have been determined through a competitive process or appropriately reviewed/ benchmarked in a manner that is satisfactory to the PoE.

2.5 Role of the PoE in Projects for which VGF Size is <u>not</u> Determined During Sponsor/ Operator Selection

In exceptional cases where a sponsor/operator is already in place or is established by the PIDG facility as part of project development, the size of the grant will be determined via a financial and economic cost-benefit analysis carried out by the PIDG facility and reviewed by the PoE. The PoE will determine whether or not it is satisfied that the grant level proposed by the PIDG facility has been determined in a way that represents good value for money and that total project costs have been determined through a competitive process or appropriately reviewed/benchmarked in a manner that is satisfactory to the PoE.

2.6 Window 3 Donor Approval

Once the PoE reaches a majority decision on the application, the Technical Advisor summarises the decision in a short memo to the PIDG donors, which inter alia, sets out the reasons for any PoE member's dissenting opinion. After a final review by the PoE, the memo, along with the application and Concept Note, are distributed to the PIDG donors for the normal 10-day no-objection period, in line with normal TAF approval procedures.

2.7 Grant Disbursement

Payments from Window 3 will be made either to the Investment Vehicle/Affiliated Programme receiving the grant or to such escrow account as agreed by the Technical Adviser, the PIDG Trust, the Investment Vehicle/Affiliated Programme, and the lenders (if any).

2.8 For Other Procedures See TAF SOPP

Other procedures for finalising TAF Window 3 VGF grants are described in the TAF General Statement of Policy and Procedures (SOPP). These include preparation of funding agreements, reporting to TAF by grant recipients, and TAF reporting to donors.

3. INFORMATION REQUIREMENTS FOR VGF APPLICATIONS

3.1 Introduction

In addition to the standard TAF application form available on the PIDG website, applicants for TAF Window 3 VGF funding also must complete a *TAF VGF Concept Note.* The section below provides an outline of the headings to use in providing TAF with a summary description of the proposed project. This Concept Note should be submitted along with the normal TAF funding application. See Sect. 2.1 above on the availability of small TAF grants to help with the preparation of these notes.

3.2 Concept Note Headings

a) PIDG Facility:
   1) Which PIDG facility (apart from TAF) is involved with the project?

b) Development Impact:
   1) Provide a description of the project's development impact.
   2) What is the estimated ERR of the project (with the capital grant included)? List the assumptions used.
   3) What is the estimated IRR of the project (with and without the capital grant)? List the assumptions used.
   4) What other project options were considered and does the chosen option represent the best benefit to cost ratio?

c) VGF Level and Timing:
   1) Maximum VGF grant required for the project.
   2) Indicate timing of VGF payments.
   3) How is the VGF grant level to be determined? If not by competition, explain why and how this will be done.

d) Beneficiaries:
   1) Who are the primary beneficiaries of the project's services?
   2) How is "poor" defined in the context of this project?
   3) Annual per capita income of expected project beneficiaries.
   4) Percentage of per capita or household income spent on the project services before and after impact of VGF grant.
   5) How are poor beneficiaries targeted and what mechanisms will be put in place to ensure positive impacts for targeted beneficiaries?
   6) Number of households expected to benefit from the project in the project area.
   7) Number of people per household in project area.
   8) Number of women and girls that are expected to benefit from the project's services in the area.
   9) Percentage of population in the project area expected to have access to the service.

e) Investment:
   1) What is the estimated capital cost of the project and how has this been determined – in particular, where the level of VGF grant itself is not determined through a competitive process, have the project costs been arrived at though a competitive process or appropriately benchmarked?
   2) How much private sector financing will be committed to the project (debt, equity)?
   3) How much financing from other sources is involved (government funding and / or co-financing)?
   4) Will the VGF grant be disbursed after equity or pro rata with debt?

f) Affordability of Tariffs:
   1) Minimum user-based revenue required to cover O&M (in US$).
   2) Average expected tariff (if relevant) for project beneficiaries.
   3) Collection rate, if relevant.
   4) Where relevant, if collected tariff is less than the minimum required to cover O&M costs, how is the gap being filled?
   5) Describe other subsidies, if any, affecting targeted beneficiaries for same service (e.g., lifeline tariff or cross subsidy).

g) Outputs and Service Quality:

1) Indicate nature of service and current availability level (e.g., average hours per day of access to the service) and comparison with existing availability and quality (e.g., number of interruptions or outages per day).
2) How will the project outputs be measured, e.g., through a PPP contract or through regulation?
3) Will any grant or performance-based payments be made on the basis of output achievement?
4) If so, indicate outputs (or milestones) and corresponding grant as % of total grant.

h) <u>Public Authority Obligations</u>:

1) What principle risks (if any) are being allocated to the public authority?
2) What is the value of any liabilities (actual and contingent) that the public authority is being asked to bear, if any?
3) Is the public authority obliged to repay part of all of the VGF in the event of authority termination?
4) How is the public authority, if relevant, organised to manage the project procurement process in an equal, fair, transparent and non-discriminatory way and deliver value for money?
5) How well is the public authority organised for subsequent management of the contract, if relevant?
6) What is the risk (if any) that the service delivered by the project will change and how easily can the project respond to such changes while delivering value for money?

i) <u>Commercial Case</u>:

1) How will competition be generated for the supply of the project inputs (capex, opex and, if relevant, finance) – it is very important that VGF is not used to supplement the profit margins of suppliers but is used to address a clear issue of affordability.

j) <u>How Will Key Project Risks be Mitigated</u>?

1) Risk that government lacks ownership of, commitment to, the project and its objectives.
2) Risk that the contractor fails to complete the project (are there performance guarantees and would TAF VGF be a beneficiary of these?).
3) Risk that the project operation is unsustainable and/or inefficient once any capital grants disbursed.
4) Risk that customers are unwilling or unable to pay tariffs.
5) Risk that service provider lacks technical, financial, and/or managerial capacity.
6) Risk that regulator or implementing agency, if relevant, is unwilling or unable to manage post-closure contract/regulatory compliance.
7) Risk that the project loses focus on service benefits for the poor after the capital grant is disbursed.
8) Risk of market distortion because of unfair competitive advantage afforded the project receiving the VGF grant.

k) <u>Conclusions – Key Alternatives Eliminated</u>?

A concluding section of the Concept Note should confirm the following:

1) That the <u>tariff/user charges</u> cannot be increased to eliminate or reduce the project viability gap;
2) That the <u>project term</u> cannot be increased in order to eliminate or reduce the viability gap;
3) That the <u>capital and finance costs</u> are reasonable and based on the standards and specifications normally applicable to such projects;
4) That the <u>capital and finance costs</u> cannot be further reduced in order to eliminate or reduce the viability gap.

4. VGF ELIGIBILITY CRITERIA

4.1 Introduction

VGF eligibility criteria are used to establish whether or not a project application meets the minimum criteria for VGF funding. The intention is to minimise as much as possible the risks associated with using VGF and maximise the development impacts.

4.2 Eligibility Criteria

Projects must meet the following criteria in order to be considered eligible for VGF funding:

a) Projects must be in DAC 1 and 2 countries. Exceptions to this rule may be considered by TAF donors.

b) Projects must have strong, demonstrable, pro-poor impacts.

c) Projects must be in the following sectors/subsectors: water, sanitation, solid waste, transportation, or energy.

d) The requested grant cannot be above 15 percent of the project's capital costs, or more than USD3 million, whichever is less. Exceptions to this rule may be considered by TAF donors.

e) The following additional project characteristics are desirable:
   1) Clear, strong positive impacts on females or female-headed households,
   2) Clear, strong climate change benefits,
   3) Located in a fragile or post-conflict state, as defined by any authoritative bi- or multi-lateral development agency.

5. VGF EVALUATION WORK SHEET

Box 1 on the next page is a worksheet that the PoE will use in evaluating VGF proposals. It summarizes the key VGF evaluation criteria that will determine whether or not a VGF proposal is recommended for approval by the PoE.

VGF Evaluation Work Sheet

Eligibility Criteria		Details	Definition/Rationale	PoE Comments
1.	**<u>Eligibility</u>**: Must be pro-poor	1.1 Targeting the poor	How well does the project target poor people and ensure that they benefit?	
		1.2 Pro-poor affordability benefits	What is the nature and size of pro-poor affordability benefits? Are they <u>direct</u> (in terms of affordable user tariffs) or <u>indirect</u> (in terms of affordable unitary payments by government)? If the latter, how effectively do these benefits filter down to the poor?	
		1.3 Other pro-poor benefits	Are there other ways in which the project benefits the poor (job creation, social add-ons, etc.)? How significant are these benefits?	
		1.4 DAC 1 or 2	Does the project meet the required country focus (DAC 1 or 2)? If not, is an exception to this requirement warranted?	
2.	**<u>Grant size</u>**: Must reflect value for money	2.1 Determination of subsidy level	Is the subsidy level determined via a competitive process for selecting private sponsors/operators (operators selected on the basis of lowest subsidy required)? If not, is an exception to this requirement warranted?	
		2.2 Underlying project costs	If competitive operator selection is not possible, do appropriate expert reviews and/or benchmarking show that the underlying project costs have been established through a competitive process or equivalent (i.e., are at a level that would have reasonably been achieved through competition)?	
		2.3 Subsidy size	A VGF grant is supposed to be big enough to transform an economically viable project into a financially viable one, but not so big as to make the project wildly profitable. Do the ERR and IRR for this project confirm this?	
		2.4 Required maximum subsidy size	Is the subsidy less than (or equal to) the required maximum size (not more than 15% of project capital costs, or US$3 million per project, whichever is less)? If not, is an exception to this limit warranted?	
3.	**<u>Risks</u>**: Mitigation is essential	3.1 Timing of VGF disbursement	**For <u>debt-plus-equity</u> projects:** • Is VGF disbursed pari passu with debt draw downs after equity subscriptions are made? • If VGF disbursement are made prior to debt disbursements are such disbursements supported by enhanced due diligence and monitoring of project milestones? **For <u>equity-only</u> projects:** • Does VGF become available only after equity subscriptions are made and construction completion is certified? • If VGF is disbursed pari passu with staged equity disbursements, are these disbursements linked to reliable project delivery milestones? **Are exceptions to these rules warranted?**	
		3.2 If premature project termination	If the project terminates prematurely, will the VGF grant be repaid from performance guarantees (for non-performance by contractors or concessionaire) or compensation for lost equity (if non-performance by government)? What other safeguards are in place regarding premature project termination?	
		3.3 market distortion	To what extent will market distortions result from this VGF grant, in the form of unfair competition, or slower than normal market development as potential future market entrants await similar subsidized loans or remain skeptical that activities of this nature will be commercially viable without similar support.	
4.	**<u>Other Considerations</u>**	4.1 What other key issues should TAF donors take into consideration?	Is there other information from the concept note, application, or direct communication with project participants, which should be considered by the TAF donors in taking a decision on this application for VGF funding?	