European Fund for Sustainable Development (EFSD) Guarantee

Potential areas to be covered by Investment Windows

Title:	Sustainable Cities

1. Policy Rationale

Background analysis: This window will contribute to achieving the United Nations' Sustainable Development Goal (SDG) #11 "Make cities and human settlements inclusive, safe, resilient and sustainable", SDG #10 "Reduce inequality within and amongst countries" and SDG #13 "Take urgent action to combat climate change and its impacts". It will be able to cover a range of investments (mainly climate-smart) in several sectors (see below) at municipal level as well as city maintenance operations.

Cities account for more than 80% of global GDP (88% by 2025 estimates). Supporting investments by municipal authorities in enabling infrastructures is key to economic growth and poverty alleviation. Investment windows set up in this area would explore innovative mechanisms to address the challenges of sustainable urban development faced by partner countries. This could include a range of priority investments falling within the municipal infrastructure sectors of urban mobility, water, sanitation, waste management and recycling, renewable energy services and energy efficiency.

Whilst cities cover a small part of the world, their physical and ecological footprints are much larger. Research indicates that they already account for up to 70% of energy use and 80% of Greenhouse Gas (GHG) emissions, as well as being significant sources of local air and water pollution and waste generation. These negative impacts are set to rise over time as a result of pressure from increasing urbanisation and climate change. At the COP21 in Paris, more than 450 cities with a combined population of nearly 1bn people pledged to reduce emissions by more than 50% in around 15 years, but only a small percentage of cities have the financing, analytics or capacity for implementing effective low-carbon growth policies.

Underinvestment and low maintenance in municipal infrastructure is also common place, frequently exacerbated by end user tariffs which are significantly below cost recovery levels. For instance, 24 countries in Sub-Saharan Africa, accounting for 70% of Africa's GDP, have spent around 2% of GDP annually between 2009 and 2015 to build, rehabilitate, or improve the existing capacity of infrastructure (in comparison East Asia countries reach levels of levels of public capital spending that exceed 10% of GDP) [1].

In the Neighbourhood, but also in Sub Saharan Africa, these shortages are particularly relevant in small and medium-sized cities where local administrations, in the context of decentralisation, have taken over competencies from the national governments, and now need to reinforce their human and financial resources to implement the related development policies.

[1] Africa Pulse, World Bank, Vol 15, April 2017

Lastly, most cities in sub-Saharan Africa and the Neighbourhood regions need to increase their currently limited capacities to access to sufficient, long-term financing and credit. The market for long-term municipal borrowing has a relevant growth potential, banks need an enabling financial and economic environment to improve their potential to offer loans matching the economic life of assets and their acceptance to take sub-sovereign risks. At the same time, debt sustainability concerns need to be addressed.

Several initiatives have been implemented in the Neighbourhood regions to help city tackle climate change challenges. In the East the most relevant is the Covenant of Mayors initiative, whose signatory cities commit to the implementation of sustainable energy policies, as well as local climate change mitigation and adaptation activities. In the South-Mediterranean region, the CES-MED (Cleaner Energy Saving Mediterranean Cities) project will pave the way for launching the Covenant of Mayors in North Africa.

As African cities will remain major energy consumers and major hotspots of vulnerability to the impacts of climate change, local authorities are critical partners in a bottom-up transition to a global low-carbon and climate resilient economy and society. The Covenant of Mayors in Sub-Saharan Africa represents an effective tool to assist African cities to deal with this major challenge.

All regional Covenants form part of the Global Covenant of Mayors for Climate and Energy, a global initiative with the three interlinked objectives of addressing mitigation, adaptation and lack of energy access at urban level.

EU Policy objectives: In line with the new European consensus on development and the revised European Neighbourhood Policy[2], potential investment windows could promote the following objectives: i) Build cities' resilience to shocks and harness opportunities for a low-emission and climate-resilient economy; ii) Promote inclusive sustainable urban development to address urban inequality iii) Create a catalytic impact on climate change adaptation and mitigation, decent job creation (in particular for youth and women) and balanced development addressing climate and environmental challenges through private sector investments at municipal level iv) Empower local authorities for better governance, better development impact and to better address inequalities within countries, notably those impacted by high mobility rates. Private investment supported by the EFSD will be additional and will not replace essential public services provided by the government.

Geographic area: Sub-Saharan Africa and the Neighbourhood regions.

Domain: Municipal infrastructure and services.

Sectors of intervention: Priority investments falling within the municipal infrastructure sectors of urban mobility, water, sanitation, waste management and recycling (renewable energy services and energy efficiency).

2. Operational concept

[2] https://eeas.europa.eu/headquarters/headquarters-homepage/330/european-neighbourhood-policy-enp_en

The EFSD guarantee shall be structured in such a way as to lower investment risks for long-term financing and create the right conditions to contribute to the provision of climate-resilient municipal services of appropriate quality. It is envisaged that a) The IFIs will work jointly with municipalities to assess and prioritise their main climate, environmental and social challenges and mobilise corresponding investments; and b) more innovative and complex transactions as well as greater engagement with the private sector will be the main feature of financial products proposed under this window.

Type of operations: Different types of eligible operations may include:

- Guarantees provided in the framework of infrastructure-focused operations in the field of urban mobility, solid waste management, water, sanitation, sustainable energy services. This includes public-private partnership schemes (PPPs). Project bonds and even "green" project bonds could also be explored under these schemes.
- Guarantees provided to grant further access to private finance to cities and local utilities, through bond issues/equity investments (directly or through special purpose vehicles bundling multiple investment projects), and/or by creating the right conditions for local public lending by commercial banks (e.g. via longer loans terms matching infrastructure maturities).
- Guarantees provided to private sector operators working with municipalities as an incentive to roll out climate smart technologies (grey-water recycling; rainwater harvesting, smart metering solutions, energy efficient street lighting etc.).
- Credit enhancement for investment funds attracting private institutional investors into developing country investments in municipal infrastructure and services.

Type of risks: Risks to be mitigated may include: i) Commercial risks (payment risk, performance risk, etc.), ii) Political and country risk (expropriation, coup d'état, civil war, etc.), iii) Legal and regulatory risk (change in law, cancellation of license, tariff adjustments, etc.), iv) Currency risks (e.g. exchange rate fluctuation, convertibility, transferability, etc.), v) Climate change and environmental risks (e.g. droughts, flooding, extreme weather events, temperature rises, etc.).

Expected Additionality: i) Private sector investments mobilised, both locally and internationally; ii) Sustainability: terms of commercial financing improved through extended maturities and lowered spreads, allowing for affordable long-term investments; iii) EU's policy objectives met as regards climate change mitigation at municipal level iv) Innovation aspects positively considered, in particular for those projects/ business models that cannot be undertaken because of their perceived high risk, high initial cost, untested regulatory framework, untested technology etc.

Envisaged Impact: i) Increase in the proportion of population that has access to basic services and public transport ii) Direct and indirect decent jobs' creation (operating and benefitting from the use of infrastructures) iii) EU climate, environmental and social standards are targeted or met, including using Environmental Impact Assessments, Strategic Environmental Assessments, and Climate Risk Assessment and Best Available Techniques, iv) Local pollution or GHG levels from the relevant municipal activity are reduced by at least 15 per cent, through investments to promote adaptation and mitigation activities.

Complementarity/Risk of potential overlap with other Investment Windows: There are complementarities with the ''Digital for Development'' Investment Window and with the Sustainable Energy and Connectivity one. There is a low risk of overlap with other Investment windows.

3. Supporting Policy Actions (links to pillars 2 and 3)

Links will be established between the investment pillar (pillar 1) and enabling policies (pillar 3) to foster conducive business environment and investment climate as well as to technical assistance (pillar 2). Implementation of this window may thus be accompanied by sector policy dialogue with the partner countries and by in-country reform processes supported by the Commission.

The most relevant policy actions may relate to:

- Decentralisation reforms in the field of domestic resource mobilisation and municipal finance.
- Legal and regulatory reforms allowing local pension funds, insurance and mutual funds to pursue long- term investment strategies, including at sub sovereign level.
- Tariff reform (where appropriate) to achieve financial sustainability at the municipal level with due consideration to affordability issues and mechanisms to protect the more vulnerable.
- Legal frameworks that enable low-emissions climate-resilient improvements at the municipal level in a financially sustainable manner.
- Policies to promote energy efficiency, in particular in the building sector by developing, adopting and enforcing "green building codes" legislation.
- Policies to promote SUMPs (Sustainable Urban Mobility Plans) approach with special attention given to the linkage of city transport infrastructure to national and regional priorities.
- Promotion of transparent utility practices as well as demonstrating the benefits of well-structured public/private partnerships.
- Policy dialogue activities which target effective and controlled private sector participation through e.g. incentive based outsourcing or management contracts.