

## Executive summary

In acknowledgment of the vital importance of water for development, the Millennium Development Goals (MDGs) adopted in 2000 include specific goals and targets to be achieved within the water sector. The target is: *by 2015 to halve the proportion of people without sustainable access to safe drinking water*. The World Summit on Sustainable Development (WSSD) in Johannesburg in 2002 made the objective even more ambitious, with strong EU support, through the adoption of a new supplemental international target: *to halve by 2015 the number of people without access to basic sanitation*.

In Africa, out of a total population of 787 million people, about 300 million (38%) do not have access to safe water and about 313 million (40%) have no access to sanitation. The situation is even worse in rural areas where out of the 487 million people, about 256 million (53%) do not have access to safe water and 267 million (55%) have no access to basic sanitation<sup>1</sup>.

Various figures have been prepared estimating the total financial requirement for the ACP countries to reach the MDGs. The figures vary because of varying assumptions regarding the type and level of service. The global cost of achieving these goals has been estimated to be in the range of USD 5-21 billion. In a recent 2004 publication AfDB's Rural Water Supply and Sanitation Initiative (RWSSI) estimated the cost of reaching the MDGs for rural water and sanitation alone in Africa to be approximately USD 14.2 billion.

The Finance Working Group of the EU Water Initiative and the World Panel on Financing Water for All in 2003 have both reached the conclusion that the present level of funding is far from sufficient for meeting the investment needs to comply with the MDGs and the WSSD targets for drinking water and sanitation. The need to increase spending for the water supply and sanitation sector has thus been acknowledged.

Therefore, in April 2003, the Commission proposed to increase the amount of Community funding available to support the EU Water Initiative in the Africa, Caribbean and Pacific (ACP) region by establishing the ACP-EU Water Facility (ACP-EUWF). The objective of the ACP-EUWF is to enhance the sustainable delivery of water and sanitation infrastructures and to improve water gov-

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<sup>1</sup> Rural Water Supply and Sanitation Initiative, Implementation and Resource Mobilisation, August 2004.

ernance and the integrated water resources management practises in the ACP countries. Hence, the ACP-EUWF intends to reduce the gap between needed and available grant financing.

The ACP-EUWF is providing grant co-financing within the framework of the 9th European Development Fund (EDF) regulations. Funding from the Facility may be used to complement, but not compete with, existing initiatives from Member States, international organisations and International Financial Institutions (IFIs).

The main funds of the ACP-EUWF are made available through a process of Calls for Proposals. The first phase of the Call for Proposals, closed at the end of January 2005, resulted in the receipt of approx. 800 preliminary grant applications requesting a total funding of €2.75 billion for projects of a total value of €5 billion. The funds available for the first Call for Proposals were limited to €180 million. Hence the demand for financing is obvious.

Compared to the financing gap the ACP-EUWF has a very limited financial envelope of approximately €0.5 billion. This supports that the aim of ACP-EUWF is primarily as a catalyst or enabler and not as a standalone financial instrument.

The Finance Working Group has identified a need to further analyse the ways that the grant funding of the ACP-EUWF could improve the use of the various financial instruments foreseen in e.g. the Cotonou Agreement to help mobilise other sources of financing, including increased international and local private sector funding for water and sanitation. It has also been emphasised that new and innovative as well as flexible financing mechanisms are required in order to obtain the maximum leverage effect of Official Development Assistance (ODA) and to attract more resources from a broader range of sources.

This is the context in which the present study "Examination of Potential of the ACP-EU Water Facility for Encouraging Increased and Innovative Financing in Water and Sanitation" has been commissioned by the ACP-EUWF.

The beneficiaries from the present study are ultimately intended to be the poor people in the ACP countries. This should be achieved through the expansion of access to adequate and sustainable clean water and sanitation services *via mobilization of increased and innovative private financing*. The increased private sector financing is foreseen from households and the communities themselves or other local or international sources. These sources should be supported by e.g. the European Investment Bank (EIB) and the Development Finance Institutions (DFIs) of the Member States.

The global objective of this study is to improve the use of ACP-EUWF funds as a catalyst for increased allocation of private financial resources, local or international, to the water and sanitation sector in ACP countries, possibly in conjunction with e.g. the EIB ACP Investment Facility, the Private Infrastructure Development Group (PIDG) initiatives and other existing facilities such as Pri-

vate Sector Enabling Environment Facility (PSEEF) and Public Private Infrastructure Advisory Facility (PPIAF).

The specific objectives of this study are to (i) provide concrete examples demonstrating how innovative financing mechanisms can be used to leverage financial resources other than ODA, and (ii) support the effective utilisation of existing financial facilities, tailoring their use to the specific needs and constraints of ACP countries.

In preparing this study the various internal EU and external programmes related to the ACP-EUWF and the Guidelines for the grant application have been reviewed. The Consultant has also made a diagnostic visit to five ACP countries, namely Kenya, Uganda, Mozambique, Sénégal and Ghana. Furthermore, the Consultant participated in the conference "Lessons from Private Participation in Infrastructure in Sub-Saharan Africa" held in South African, Cape Town 6-7 June 2005, where a number of representatives of the water sector were presenting their cases for private financing or participation in the water sector.

Stimulating increased private sector finance in water and sanitation in ACP countries is a significant challenge as it can even be difficult to stimulate private sector finance in this geographic region in more commercially oriented sectors often viewed as more attractive from an investment point of view. This is due to a variety of reasons, including among others a difficult macro-economic situation in many ACP countries; low level of development of local financial markets; exchange rate instability, corporate governance issues, and a high level of non-commercial risks perceived by the private sector for long term investments in many ACP countries. Consequently, there are several impediments to long term private capital commitments.

The specific obstacles to private financing in water and sanitation as experienced in the five countries visited can be summarised as follows:

- The main and basic problem to private financing of water projects in many ACP countries is that no private investor can be sure that the water project will generate sufficient revenues over a relatively long period of time which ensures a repayment of the investment combined with a reasonable return. The commercial and political risk is simply too high.
- The water tariffs charged are presently not full cost recovery tariffs (except for urban water in Sénégal). Typically the water companies are only able to charge a tariff which covers the O&M costs. Often, this is not even sufficient if the collection efficiency is taken into account. There is no allowance or provision in the tariffs for new investments or often not even for preventive maintenance functions. Some small town water schemes may be able to collect revenues including O&M as well as depreciation, if they have been donor funded. If not, the tariffs cover only operation costs.
- Water pricing policies are in general not transparent with clear guidelines for what cost items can be included in the water tariffs. Hence, there is a

need for a revised tariff structure, which provides for full cost recovery and which has been established in a transparent manner.

- Autonomous water service providers with separate accounts, managerial, commercial and financial autonomy, combined with clear and consistent objectives are not in place.
- A clear regulatory framework, which secures a proper enabling environment is, generally, not in place;
- Poverty in rural and peri-urban areas makes user financing of service area expansion very difficult due to low ability to pay. In urban areas where there may be an ability to pay for better services among at least part of the population subsidies are often blanket subsidies rather than targeted towards the poor.
- The system capacity (i.e. the water production capacity) in many countries continues to be below current demand.
- Lack of political will to introduce "water as an economic good" in practical terms (viz. full cost recovery tariffs and not uncritically adopt "European" standards for service provision, but accept the service level the users are able and willing to pay for).
- Many of the water companies servicing the urban population used to be (or still remain) highly indebted and unable to service the debt. In some countries there is an ongoing negotiation process to write off part or the whole of the debt of the water companies as part of the highly indebted poor countries (HIPC) debt relief policy.
- Regulators are new concepts and either not yet in place in most countries or still infant institutions.

The general findings on financing mechanisms and other institutions participation in the water sector in the five countries visited can be summarised as:

- The banking sector in the region has very limited experience with financing water projects.
- Micro-finance is a new option to be pursued within the water sector, as it has not commonly been used in the sector in Africa. Micro-finance is however increasingly being used in other sectors and in particular for commercial activities throughout the continent. There are indications that commercial banks can and will participate in micro-financing of small scale investments in the water sector through micro loan schemes, but also through normal banking activities if a water project is financially viable and the applicant is creditworthy.
- Bank or loan financing from the domestic capital market has only in a very few cases been used as a source of finance for water infrastructure invest-

ments and in these cases only against a guarantee or letter of comfort from the government.

- Bond issues (be it Treasury bonds, Municipal bonds or asset holding company bonds) are not likely sources for investments within the medium-term horizon in any African country except possibly in South Africa and Sénégal. These may be out of reach even with credit enhancements through guarantees or other instruments. The reason is that the asset holding companies are only in the process of being established in countries like in Kenya and Uganda and such companies need a few years of prudent operations before coming creditworthy and thus able to issue bonds. Furthermore, the bond markets are not very liquid and there is no tradition for issuing bonds (neither Treasury nor municipal bonds) for water and sanitation projects. No municipal bonds have been issued yet in the countries visited.
- The sources of finance for water and sanitation infrastructure are mainly donor grants and concessional loans (more than 75% and for most countries 90-95%). Thus domestic financing of water projects is very low.
- User or beneficiary finance is an option to be explored in greater detail. However, there are at present severe difficulties in collecting the present (low) user contributions in the rural and small town projects, especially outside the harvesting season.
- During the diagnostic missions, only very few people had heard about the various programmes in existence like PIDG initiatives, PIAFF, ProInvest, etc. This was obviously not the case among the international donor community, but outside this community and even among some bilateral donors there was a clear lack of awareness of these programmes. Similarly, they were not acquainted with the different available financing instruments. Hence, there seems to be an obvious information gap.
- Output Based Aid (OBA) is not used in any of the countries visited but a pilot project is underway for using OBA in Kenya, Uganda, Zambia and Ethiopia. The pilot project was launched for tender among various municipalities during the time of this assignment.

Based on the diagnostic missions and a review of the financial products offered by various EU and external programmes the following main barriers for financing water and sanitation in the ACP countries have been identified:

- *Lack of local currency instruments.* Loans in local currency are the most appropriate way of financing water infrastructure investment since water revenues are generated in local currencies.
- *Limited sub-sovereign lending.* This is due to the 1<sup>st</sup> class guarantees required by most financing mechanisms but only reluctantly issued by national governments.

- *High debt level in utilities reducing borrowing capacity.* High debts in water utilities have been incurred as a result of a number of reasons including high investment and operating costs combined with water tariffs set far below cost recovery levels.
- *Low capacity to pay for water and sanitation services.* In urban and peri-urban areas and in particular in rural areas.

Five concrete examples for innovative financing mechanisms in an ACP context have materialised during the diagnostic missions which potentially can increase the leverage from ACP-EUWF resources. The effective utilisation of existing financial facilities as well as the proposed financing modalities may enhance the use of ACP-EUWF funds as a catalyst for increased allocation of private financial resources to the water and sanitation sector in ACP countries.

### **1) Sub-sovereign, local currency loans for water and sanitation**

Limited sub-sovereign lending and lack of local currency instruments have been identified as critical barriers in closing the finance gap. There is a high demand for local currency loan at affordable rates and with a sufficiently long tenure. The demand for financing water and sanitation projects in domestic currency is unquestionably high in the ACP countries as all revenues generated from these projects are in local currency. However, not all project holders or proponents are backed by a creditworthy and independent organisation. The ACP-EUWF has the ability to use development assistance to leverage other forms of finance and bringing funding directly to the local level, to municipal/local governments. Hence, the ACP-EUWF can work as a catalyst for promoting resource mobilization.

The EIB ACP Investment Facility offers the possibility to provide loans denominated in local currency and such loans, blended by the ACP-EUWF grants and possibly other grants from other donors, can find a relatively easy placement. This blending would be quite unique on the market today.

The rationale behind this blend is that although guarantee instruments which may enable sub-sovereign loans (partial credit guarantees) in local currency (exchange rate risk coverage) are in principle available on the market (e.g. through the EIB ACP-IF and others) - they are market priced thereby making them prohibitively expensive for water projects. If ACP-EUWF grants were available for financing water projects it could make EIB ACP-IF loans more attractive to water projects as well as reduce the cost of partial credit guarantees and exchange rate risk coverage. This would provide true leverage between the ACP-EUWF and the EIB ACP-IF and other financing institutions.

### **2) Exploiting synergies with regional development banks**

It can be suggested that the ACP-EUWF contact the regional development banks in the ACP countries. These regional development banks have a large network and have knowledge of water projects in their pipe-line. The point is that the regional development banks can benefit from the existence of the ACP-EUWF, and thereby can the ACP-EUWF work as a catalyst and leverage financing of projects in the regional development banks. If the regional devel-

opment banks are aware of the Facility they can inform their project holders of the possibility, who then can apply to the ACP-EUWF. Again, as is the situation with the EIB ACP-IF, the Facility can by the mere existence of the grant element in the project financing reduce the cost of various guarantees and loans as the project risk is reduced.

### **3) An OBA model targeting the private WSPs**

OBA is a strategy for supporting the delivery of basic services; i.e. the provision of water and sanitation services, that depend in part on public funding (at least for infrastructure investments but possibly also for covering O&M) where payment is linked to service delivery. OBA enables a pro-poor approach to tariff reform that enhances the financial viability and borrowing capacity of water utilities and generates more sustainable service expansion projects.

Although EDF rules and procedures<sup>2</sup> are still mainly focussing on financing inputs (works, supply and service contracts), the ACP –EU water facility shall further explore the possibilities to co-finance certain innovative proposals involving OBA. The ACP-EUWF can not presently be engaged in all cases where the OBA approach can be applied without changing the current EDF procedures. It is only recommended that the ACP-EUWF is involved in OBA projects if the implementation of the proposals is still similar to traditional investment projects (implying open and transparent tender procedure for specified outputs). Any OBA projects which would require transitional tariff subsidies or continuous tariff subsidies are not recommended for ACP-EUWF funding.

The rules for the ACP-EUWF allow for grants directly to multilateral/multi-donor organisations. The World Bank operates a trust fund for GPOBA. It is suggested and encouraged that the GPOBA or another international organisation applies to ACP-EUWF for the provision of grant funding for a maximum of 50% contribution for projects they support in the water sanitation sector for projects organised as an OBA project.

OBA models could offer advantages when the intention is to secure funding for several or many projects, in particular those of smaller size. Such a structure could in particular reduce transaction costs for individual projects and financing costs for the pool. An OBA fund could initially be capitalised by the ACP-EUWF, GPOBA, other external aid funds or government resources.

### **4) Restructuring the debt ridden balance sheets of water utilities**

Highly indebted water utilities represent a major challenge in relation to closing the finance gap for water infrastructure investment. In a number of occasions donors (as for example WB and KfW in Senegal) have been willing to make debt for equity swaps thus restructuring the balance sheet of utilities with the aim of reducing existing debt service and paving the way for financing new investments through international or local financial institutions.

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<sup>2</sup> An important exception being the sectoral and macro economic budget support where disbursement are directly linked towards outputs.

It should be emphasized that debt for equity swap has been instrumental in the balance sheet restructuring of SONES in Senegal thus contributing to the financial balance of the holding company and further to the successful development of the urban water sector of the country.

The ACP-EUWF is thus encouraged to promote the use of debt for equity swaps in cases where there is a real potential for sustainable development of the sector if coupled with tariff reforms. However, the ACP-EUWF should not directly engage itself in debt for equity swaps unless the local Ministry of Finance is accepting to write off a significant amount of the utility debt. The consultant suggests considering if debt cancellation by a Ministry of Finance of a water utility could be taken into account as a local contribution, and under which conditions. The ACP-EUWF could then step in with grant money when the balance sheet is restructured and the water utility company becomes a solvent and the utility profitable. This could leverage additional local financing.

#### **5) Supporting the development of microfinance schemes for rural or peri-urban water and sanitation projects**

The development of micro-finance schemes has been identified as a potential focus area for the ACP-EUWF because rural households and communities investing in small water infrastructure and household facilities otherwise will be left with no real financing options.

The challenge is to develop a financing mechanism which will enhance community contributions and with blending of financial instruments could make the mechanism affordable for rural or peri-urban communities.

Recognising that the ACP-EUWF is pro-poor oriented and thus addressing the poorer segment of the societies within low-income countries where the affordability to pay for water and sanitation services is low, the ACP-EUWF is encouraged to enter into micro-finance projects. In this way the ACP-EUWF can thus directly address the poorer segment of the population. There seem to be several user groups or community based organisations (CBOs) who are interested in improving the water services but do not have the financial means to do so. However, if the ACP-EUWF can provide the grant part for this improvement the demand for such services is high. Hence, if a project can be proposed say by an international organisation to establish a Fund at a financial intermediary (targeting small-scale user groups or CBOs), and where the financial means of the financial intermediary is also utilised this could to a large extent leverage domestic financing of water and sanitation projects.

It can be further suggested to include the EIB in the above activities aiming at consolidated microfinance instruments for water and sanitation, as they are entitled through the EIB ACP-IF to capitalise such a fund and/or provide partial risk guarantees for these operations.

The main funds of the ACP-EUWF are made available through a process of Calls for Proposals. This is a unique delivery mechanism and should be kept that way. However, international organisations could to a larger extent make

use of the Facility, as follows from the above innovative financing mechanisms in an ACP context.

It is important to emphasise that the ACP-EUWF is pro-poor oriented and is thus addressing the poorer segment of the societies within low-income countries where the affordability to pay for water and sanitation services is low. This implies that expectations should not be too high on receiving too many innovative financing proposals in the Calls.