



## **The European Union Water Initiative: Final Report of the Financial Component**

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**3.1***INTRODUCTION*

The working assumption of the EUWI finance strategy is that adequate sources of non-aid finance do exist to help meet the water sector MDGs, but that the water sector in developing countries fails to attract and retain them. There must be some common constraints to financing the sector from sources other than WU aid alone.

Consequently, rather than lobbying for simply more water sector EU aid, might it be the case that existing aid commitments could be used more effectively if they were targeted instead toward alleviating the constraints that stop these other sources of finance becoming available for investment in the water sector? In this way EU aid could therefore help to leverage a greater amount (and mixture) of other sorts of finance into the sector. This is consistent with the goals of the EUWI finance component and would ultimately help meet the EUWI targets.

The objective of this section is therefore to:

- Explore the wider range of non-aid finance sources that may be available to a regional water sector;
- To identify some common constraints that stop them being used more fully; and
- To suggest some ways in which EU aid may be better targeted to overcome these constraints, thus acting as a lever to attract more of this finance.

Importantly, in using EU aid to overcome these constraints, this section also highlights where there may be existing initiatives for the regional finance components to build upon.

To meet the objectives of the section, two questions are addressed.

1. What are the key constraints, which prevent the gaps in finance described in Section 2 from being filled?
2. How can these constraints be alleviated, so as to lever more finance into the water sector?

Annexes D and E support this section. While, the case study process focuses on sub-Saharan Africa, it is hoped that the general approach taken for

investigating constraints to finance and ways of mitigating them, can be of wider use to the regional components of the EUWI in their finance investigations.

### 3.2 SOURCES OF FINANCE

It is important to recognise that the range of EU financing sources and mechanisms potentially available for increasing investment in the water sector in developing countries, incorporates more than just overseas aid grants for water projects alone.

For example, there are several different ways of providing aid money to help develop infrastructure; there are a number of aid mechanisms designed to lever more money from the private sector into developing countries; use is a range of ways in which finance can be obtained from the domestic population or water users; and there is also a range of finance sources potentially available from the national and international private sectors.

The following text box attempts to list the “menu” of sources and mechanisms for financing for the water sector, which could potentially be exploited more so than at present to meet the financing challenge. (Grant-based overseas aid is included as one type of grant).

#### **Box 3.1 *Finding more finance for the water sector: sources and mechanisms***

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|---|---|
| <ul style="list-style-type: none"><li>• From water users or the domestic population (via tariffs, taxes and subsidies, and environmental charges)</li><li>• Grants</li><li>• Loans</li><li>• Mixed Credits and Export Funds</li></ul> | <ul style="list-style-type: none"><li>• Bond Markets</li><li>• Equity Stakes</li><li>• Direct Private Investment</li><li>• PPP/ PFI Initiatives</li><li>• Voluntary Finance Schemes</li></ul> |
|---|---|

There are also a number of different ways for donors to provide their grants to water sector projects, such as through the use of micro-finance or output based aid approaches, sector wide approaches and sectoral funds.

#### *Output Based Aid (OBA)*

Under OBA schemes, overseas aid to private firms, NGOs, or the public sector is linked to clearly defined performance indicators. Thus, as development practices shift towards more demand-responsive development approaches, output-based aid provides a practical way to monitor and evaluate the progress and effectiveness of aid funding over time.

An output-based strategy for water can be applied to subsidies and tariffs, contracts, and programs, for example through the PRSP process. As part of the process, donors and recipients need to establish the role of funding, clarify the responsibilities of all parties, define

performance, determine how the scheme will be administered, and link payment to performance.

The more widespread use of OBA principles linked to grant funds may raise the profile of cost recovery and other targets for sustainability in the water sector, along with promoting accountability in both systems and financial management.

Currently, the World Bank and DFID are interested in developing OBA approaches.

*Annex D* provides a detailed explanation about each of these sources and mechanisms of providing finance.

### 3.3 *CONSTRAINTS TO FINANCE*

Nevertheless, despite this range of finance sources and mechanisms, there is currently a large gap between the amount of finance being provided and that which is required to meet the EUWI's goals. It is clear that these sources and mechanisms are not being used to their full potential. Current levels of both private sector finance and domestic finance are particularly low, in general, relative to the challenge.

The analysis sought to identify a range of obstacles or constraints to financing the water sector, from finance sources other than aid alone. The aim was to pin point some common groups or types of constraint. The identification process was undertaken with help from the Working Group, but it also drew upon key reference points from the report of the World Panel on Financing for Water Infrastructure.

#### **Box 3.2** *The "Roots of the Problem" According to the World Panel on Financing Water Infrastructure*

##### *Roots of the Problem*

The Panel's final report contains a section entitled "The Roots of the Problem" (section 3 pp 9-11). It is here where constraints to the attraction of more private sector finance into the water sector are explored. Broadly the Panel identified the following range of issues as important constraints

- Apparent low priority given to water sector by central government
- Political interference
- Poor management structure and imprecise objectives of water undertakings
- Inadequate general legal framework
- Lack of transparency in award of contracts
- Weak and inexperienced regulators
- Resistance to cost recovering tariffs
- Foreign exchange risks
- Sub sovereign risks
- Political and regulatory risks
- Contractual risks

- |   |
|---|
| <ul style="list-style-type: none"><li>• Risks of low sector rate of return</li><li>• Risks related to capital intensity of projects</li></ul> |
|---|

Each of these issues identified by the Panel is a complex issue. Many of them are captured in detail in the Panel's report and were also discussed by the EUWI Finance Working Group.

However, in order to be as practical as possible, it was important to group this range of complex issues (and others, which the working group thought were also important) into manageable blocks, containing similar types of constraint or similar sets of problems.

The Finance Component consequently identified four groups of common constraints.

- Commercial Risks
- Political Risk and Governance Issues
- A Lack of Good Projects
- A Lack of National Capacity

Each groups is expanded upon below.

### 3.3.1 *Commercial Risks*

Commercial risks may include:

- *Foreign exchange risk* – revenues from water projects tend to be generated in local currencies, which poses a risk to external investment because of exposure to foreign currency fluctuations. This risk can be coupled with other financial risks during periods of macro-economic instability. Foreign exchange risk can be mitigated through the raising of local currency funds wherever possible. However, there is often a dramatic lack of local investors and the local capital markets are often underdeveloped.
- *Contractual risk* – water sector contracts tend to have a long life which, when combined with a lack of uncertainty, <sup>(1)</sup>can bind operators into providing a service in a changing operating environment, exposing them to a greater degree of risk. In any investment, therefore, the timeframe is critical and a thorough country analysis must be performed

(1) e.g. uncertainty in assessing viability of capital investment programs at a time when future revenue prospects from such programs are not transparent.

up-front, notably in view of defining the clauses for eventual contract renegotiations.

- *Risks in operating water and sanitation businesses;* for instance in introducing efficiencies in billing systems and tariff collection or reducing water losses from leakage or theft. These types of risk are usually readily accepted by the private sector;
- *Risks in undertaking capital investment programmes* for water or sewerage trunk mains and reticulation systems. The commercial risks here are relatively low, because exposure to uncertain sub-soil risk means it is usually impractical to require fixed price contracting.
- *Risks in constructing water or sewage treatment plants.* Here lump sum fixed price contracts are often used, hence the commercial risk can be managed perhaps via the use of output-based specifications.

In general, these kinds of commercial risks are normally acceptable to the private sector. Commercial risk can be mitigated by negotiating well, maximising levels of debt leverage and through the use of risk guarantees.

Private sector operators often require a guarantee on their investments to address the variety of commercial risks associated with operating in developing countries. Often, these risk guarantees are likely to be backed by international institutions, and sometimes partially by Sovereign governments if the institutional environment is strong enough.

Risk guarantees act as a form of insurance for loans associated with financing infrastructure projects. They serve to neutralise country risk, and can be used for more favourable lending terms. A recent recommendation for a major form of commercial risk guarantee was presented in the Final Report of the World Panel on Financing Water Infrastructure. The report recognised foreign exchange rate risks as a major constraint to attracting more financing into the water sector. It recommended a Backstopping Liquidity Fund to help protect the private sector against such currency fluctuations. Such a fund would help, in effect, to provide a guarantee against this risk.

However, another mechanism for risk guarantee is already in play and could be enhanced through the EUWI. This is the *Development Guarantee Company (GuarantCo)*, an initiative developed by the multi-donor Private Infrastructure Donor Group (see *Annex D*). GuarantCo provides partial risk guarantees for local currency bonds issued by municipalities and utility companies for infrastructure works, and to offer to put operations to local banks for loans to municipalities and utility companies for infrastructure works. Feasibility studies for GuarantCo were undertaken in mid-2002 and the company has recently been formed.

Within the water sector, however, the involvement of local and national governments as part of a financing consortium can often increase the perceived risk, due to the increased possibility that these governments might call in a bond or breach the contract depending on their political and financial situation. The same risk is valid for poorly or non-regulated markets.

Risk guarantees are useful tools to facilitate investments in areas where commercial project development might otherwise be unfeasible. However, it seems that a key risk perceived to be present by debt providers (the providers of finance) is often the *political risk*, rather than simply the commercial risk perceived by operators. Hence, as well as providing ways to minimise commercial risk, it may be more (or as) useful for EU donors to explore ways to minimise political risks to satisfy debt providers so that a private (or public) water firm can leverage enough affordable finance to undertake an improvement programme.

### 3.3.2

#### *Political Risk*

Debt providers are generally concerned at the *political and regulatory* risks to an operator's revenue forecasts. Interference by politicians and an unstable regulatory regime can alter market conditions and impact on water projects. These can be more important than the commercial risks which operators face and can mitigate against. These concerns tend to be associated with the potential political sensitivity of a water project, particularly at times of economic downturn when the following issues may become pertinent:

- Enforcing payment on defaulters by cutting off water supply;
- Securing regular tariff increases in practice, even if consistent with the relevant regulatory system or concession agreement;
- Obtaining permitted tariff increases to cover the effect of exposure to domestic currency depreciation from having long term debt denominated in foreign currency or any need to pay hard currency-linked dividends to equity invested by offshore shareholders; or
- Sub-sovereign risk – governments have been increasingly devolving responsibility for water services to sub-sovereign bodies, which do not, however, have equivalent powers to raise finance.

In addition, there may be uncertainty about the viability of capital investment programmes that may be required under a license or concession agreement, but which possess uncertain cost characteristics (or on the process of testing that viability with a regulator), at a time when future revenue prospects from the project are not clear.

Issues such as climatic variability (drought or climate change) may have specific impacts on water resources, and can add a perception of external risk to the project through their potential to affect project performance over the long term.

Interestingly, at the time of writing, the PIDG are also investigating the setting up of a programme of political risk insurance.

### 3.3.3 *Issues of Governance*

Many of the issues associated with political risk are embedded within the wider context of a stable enabling environment or good governance for the water sector. An unstable policy environment or a perception of opaque, undemocratic governance can be a constraint to attracting the finance required for the water sector to improve. Specifically, a lack of maturity in the policy environment for water in the recipient country (with regards to legislation, regulation, institutional framework, level of decentralisation, political commitment to tariff reform for example) is seen as a key constraint.

A poor governance environment for water can lead to the following:

- A lack of availability of favourable long-term debt conditions and mechanisms necessary for the long-term investments required for water related projects, due to policy or regulatory uncertainties;
- A difficulty in mobilising local currency guarantees due to high levels of currency uncertainty;
- Lack of trust in the long term political desire or will to adjust water sector policies or tariffs;
- Lack of commercial independence for national water sector operators or regulatory bodies;
- A lack of institutional and regulatory harmonisation resulting in different ministries with different, and sometimes conflicting, responsibilities for water.

What does a good governance environment look like for the water sector?

*Annex E* provides some general guidelines as to what “good governance” in the water sector could look like. It can be used as a start or reference point from which a recipient country can assess to what extent its political environment is as amenable as possible to the finance available for investment in the water sector. The guidelines provide some good governance ideas for facilitating:

- The role of public authorities;
- The contribution of civil society;

- The contribution of water operators and other service providers; and
- The contribution of financial institutions.

It is important to stress that *Annex E* provides guidance information only, and should not be read as a one-size-fits all blueprint for good water governance, nor as some form of conditionality tool, without which finance for water will not be forthcoming. It simply provides some guidelines.

There are also, however, some wider governance issues which present trans-national challenges. For example:

- Trans-boundary issues are particularly relevant to water projects because of the need to coordinate efforts in multiple regions. Conflicts over water allocation or problems of pollution across river basins may add further risk to successful policy implementation or project delivery.
- For irrigation projects especially, there is the problem of wider water subsidies existing in the EU. How will it be possible for the EU family to promote good governance and efficient pricing policies in recipient countries within this wider context of policy non-harmonisation?
- There can often be great difficulty in ensuring that all members of the EU family agree with the same broad objectives and principles of action for aid for the water sector. A lack of coordination or harmonisation in project designs, levels of subsidy and types of finance on offer can create missed messages and cause inefficiencies in policy delivery. Lack of coordination also absorbs scarce resources, which could be spent more effectively. These issues create governance challenges within the EU for improving aid delivery to the water sector.

### 3.3.4 *A Lack of Good Projects*

A common complaint from EU donors was that there is a lack of well-designed projects or programmes in the water sector for them to fund. This may be due to:

- The high up front costs of project preparation.
- The perception of investment in the water sector as a short-term goal instead of being a tool to ensure the long-term provision of cost effective and affordable services to different type of users. Too often water sector projects are designed by recipient countries as “prestige” capital investment show pieces (a large dam and reservoir, or the rehabilitation of

a major city's water supply and network and treatment plant, for example), with less attention paid in the design to the longer term commercial or financial sustainability of the investment than to the up front capital required.

- The large differences in policy, design, financing requirements and issues of risk that face the next generation of poverty-reducing water projects that are required in rural or peri-urban rather than urban areas or small rather than big towns, which are not being adequately addressed at present in the project design process.

On this last point, it is often difficult in the project design process to identify at what level the local counterpart for the smaller water project should be based – national, regional or local – for different types of project. For a small town project, a local level counterpart (municipal water authority) may be too small an entity to be able to provide satisfactory sub-sovereign guarantees. A counterpart at the regional level, however, can create the possibility of aggregating a number of smaller town projects together. Given the high cost of mobilising private and public resources, the regional scale counterpart maybe the more appropriate level for water projects focusing on smaller towns. However, the multi-disciplinary expertise and experience to design such “aggregation” projects - to bring multiple local stakeholders together to agree on project design and their own commitments and which contain commercially viable components, is often extremely difficult to find or mobilise within country.

In rural or peri-urban areas, there is also a challenge in designing affordable, demand-driven projects for the poor – these tend to be very local, small scale and communally owned schemes which don't offer an obvious potential for either scaling up into a larger programme, or for returns on external financing. Careful thought on policy design must be given to issues of cross subsidisation, innovative payment mechanisms and/or local credit facilities for these poorer customers.

Furthermore, to attract wider sources of finance to these projects, the commercial viability of a project's design must be assured from the inception by means of a number of clauses, which foresee the possible events that would off-balance the established return on the investment and the initial risk assessment. Such clauses should allow the periodic renegotiation of the price and performance conditions of the project as well as the redefinition of the project framework.

In short, to meet the EUWI targets for water and sanitation, the design of robust projects and programmes in non-municipal areas, that can also attract wider sources of finance, is a key constraint. A number of project preparation

initiatives and proposals have been developed to help mitigate these constraints, however, and could be refined further. These include:

- The Project Preparation Committee;
- The Infrastructure Development Company; and specific to Africa,
- The African Water Facility.

#### *The Project Preparation Committee (PPC)*

The Project Preparation Committee (PPC) is a networking mechanism established in 1993 to improve coordination and cooperation between IFIs, donors and countries in transition to facilitate environment related investments in CEE and the NIS. The PPC Secretariat is based in London at the EBRD, with officers designated to implement the PPC mandate located at the EBRD and the World Bank.

The PPC works by trying to 'match' donor grant funds for investment support or technical assistance to potential IFI loan finance for environmental projects, which have been given priority in this region and which fit the priorities of the EAP. Hence, the PPC is not a fund, a clearinghouse or a mechanism to evaluate projects. It deals only with projects co-financed by donors *and* IFIs, and does not deal with projects of a national or bilateral nature.

Project proposals are submitted by the National Government through normal channels to the IFIs or the bilateral donor. After the Central and Eastern European partner and the donor or bank have agreed on the contents of the project and the co-financing needed, the project can be presented to the PPC by one of the donors or IFIs that constitute the PPC.

PPC donors contribute to the PPC in several ways. For example, they provide:

- Grant aid to the countries of central and Eastern Europe and the NIS in preparing projects before they are submitted to the IFIs for consideration;
- Support for technical assistance aimed at institutional strengthening and policy development, a prerequisite for the implementation of sound investment projects;
- Support for technical assistance for projects on which IFIs are working. This can be done by specific PPC 'trust funds' established at the IFIs (e.g. by Japan, the Netherlands and by Switzerland), by specific contributions through bilateral assistance, or through other established mechanisms (such as general consultants 'trust funds');
- Co-financing for environmental investment projects. Donors can finance projects jointly or co-finance with IFI loans in the form of joint financing or parallel financing; and
- Funding for staff (PPC officers and PPC Secretariat) is primarily based at the EBRD and the World Bank.

Since its creation, the PPC has been effective at minimising the “revolving door” problem suffered by recipient country governments, when faced with a host of enthusiastic donors in the environmental sector. It has also allowed the finance available for environmental projects to be used more effectively, rather than necessarily leveraging in more money in total.

The EU water initiative could seek to build on the PPC for a better preparation and selection of projects and could seek to adapt this mechanism to other priority regions, particularly Africa.

#### *Infrastructure Development Company*

The *Infrastructure Development Company (DevCo)* is an initiative proposed by the multi-donor Private Infrastructure Donor Group (see *Annex D*). This would be a project preparation facility seeking to develop potential infrastructure projects to the point where they can be offered to private sector companies on a transparent, competitive basis. Implementation would be by the private sector alone or (commonly) working in partnership with other stakeholders in-country. Successful bids would be charged a levy to recover operating costs.

#### *The African Water Facility*

Supported initially and primarily by the Dutch Development Agency and with significant support from the African Development Bank, the African Water Facility (AWF) was conceived at a series of meetings and dialogues that have taken place over the last few years as a stepping-stone to meet the targets and goals for the water sector that were established by the African Water Vision and the Millennium Development Goals (MDGs). It was launched at the 3rd World Water Forum in Kyoto, March 2003. The AWF also aims to take advantage of the momentum that has been growing politically, through initiatives such as the New Partnership for Africa’s Development (NEPAD), the African Ministers Conference on Water (AMCOW), and the African Water Task Force (AWTF).

The primary objective of the AWF is to provide investment support for water resources management and water service provision in Africa. It aims to raise multi-donor and other funds to provide:

- A grant facility aimed at preparing projects and programmes and facilitating investment; and
- An investment facility to provide loans to finance strategic projects and programmes which would catalyse additional investments.

It is envisaged that the African Water Facility will operate through a number of different windows, providing:

- Grants for Sub-Regional and Trans-boundary Water Resource Management Program Development;
- Grants for National Level Reforms, Strategy Plans and Legislation: This would provide incentives for and support to those governments that propose to implement sector reforms through necessary legislation amendments and institutional reforms. Grants would support activities such as: cost of developing the reform program, meeting initial labour costs of rightsizing central ministry and local authority staff structures, or the costs of safety nets or easing the political costs of tariff reforms and of well-targeted subsidies for the poor in the context of local tariff reforms. A specific focus of grants would be to assist countries incorporate water more centrally in national poverty reduction strategies;
- Budget Support for Water Investments: This window will provide budgetary support to countries, where political commitment is high, the policy framework adequate and where there is an appropriate institutional structure, for Water sector operations through a loan-grant mix; and
- Grants to Establish a Benchmarking and Monitoring Facility: this would provide comparative performance assessment for all African countries on agreed performance indicators to assess: a) level of country commitment on IWRM and WSS sector reforms, b) progress on implementation of IWRM and WSS sector reforms, both institutional, financial and coverage, c) overall country framework for fiscal and governance reforms, d) progress and performance on development and implementation of country's PRSP, and e) extent and nature of IWRM and WSS components in country owned poverty reduction strategy papers.

A wider problem of project design not explicitly captured by these initiatives relates to the problem of insuring against issues of water mis-allocation among different users (competing uses for irrigation, potable water and environmental preservation). For example, pricing policies for irrigation based on non-cost recovery can negatively affect the allocation of water resources for other uses (e.g., industry, public water supply). In these cases, there is a need to further develop the objectives of IWRM within the project preparation process, an issue of pertinence to the EU Water Initiative.

### 3.3.5

#### *A Lack of National Capacity*

Another common constraint identified is the lack of capacity within country to design, implement or regulate new water sector projects. Capacity constraints can be prevalent in the public sector, the local private sector and in civil society.

A lack of public sector capacity, particularly at the local level and following a process of decentralisation, is commonplace. Often, this manifests itself in the difficulty public sector employees have in shifting from being service providers to regulators; from being lobbyists seeking funds from central government to “clients” overseeing consultants developing project designs for their town or region; or from being part of a centralised line ministry to an autonomous decision maker deciding upon the most cost effective way to set and manage budgets, meet targets and utilise a range of revenue, grant, subsidies and debt-financing options.

A lack of local private sector capacity can also be an associated problem. Often the local private sector has limited experience in providing elements of the supply chain for water supply projects, as this was traditionally the role of large public sector agencies; consequently dealing with contracts, time-bound or output-based responsibilities for service delivery and cash management issues can often be difficult without the requisite project or business management skills in place.

Finally, there is often a problem of a lack of capacity among civil society to cope with new approaches for water project delivery. NGOs have to shift from being solely implementers where previous gaps in public sector delivery existed, to also becoming advocates of change and best practice within the public and private sector. A better understanding of financing, regulatory and contractual issues is required. Similarly, local communities and water user groups, when given the space to design, manage or implement their own projects, may also need capacity building in skills such as decision-making, accounting and bookkeeping, monitoring and evaluation and communication and negotiation with key stakeholders in government and the private sector.

### **3.4**            ***HOW CAN THESE CONSTRAINTS BE MITIGATED, SO AS TO LEVER MORE FINANCE INTO THE WATER SECTOR?***

#### **3.4.1**        ***Introduction***

Given these groups of constraint, this section explores how EU aid might be used more effectively to help overcome them, in order to leverage more and different forms of finance into the water sector.

To help guide this analysis, reference was made to the long list of proposals and recommendations related to attracting more finance into the sector, which the World Panel on Financing Water developed (pp14-34 of their final report). These proposals were grouped broadly under two headings - Governance and Sector Reform and Financial Instruments and Facilities - and were then clustered under the sub headings, as shown in the box below.

*Issues about which the World Panel on Financing Water offered proposals*

<b>Governance and Sector Reform</b>	<b>Financial Instruments and Facilities</b>
<ul style="list-style-type: none"> <li>• Central Government</li> <li>• Sub Sovereign Entities</li> <li>• Promoting Local Capital Markets and Savings</li> <li>• Sustainable Cost Recovery</li> <li>• Increasing Managerial Capacity</li> <li>• Corruption and Ethical Practices</li> <li>• Legal and Regulatory Environment</li> </ul>	<ul style="list-style-type: none"> <li>• Multilateral Funding Institutions</li> <li>• International Commercial Lending</li> <li>• Export Credit Agencies</li> <li>• Private Investment and Operation</li> <li>• Community Initiatives and Service Orientated NGOs.</li> </ul>

This list contains over 150 separate proposals and recommendations and there are many detailed and useful ideas, which the EUWI can draw upon from this report. However, while the Panel’s proposals contain many sound ideas in principle, the practical “how-to” component of their proposals, may be less immediately apparent to decision makers involved in the EUWI

Consequently, and building on the Panel’s work, the focus of the EUWI and its finance component is to pinpoint *specifically* for the EU aid family where better focused EU aid could help to leverage in more and other sources of finance for the water sector. Thus, the areas for action in this report are presented a little differently to the Panels’ portfolio of proposals. To maintain a practical policy focus for the EUWI, some suggested ways of using EU aid more effectively, in order to overcome these key constraints and leverage in more and other forms of finance, are presented. However, these are done so from the perspective of the four key stakeholder groups who will be most involved in the EUWI, namely

- Water users;
- Water service providers;
- Government – both sub-sovereign and sovereign entities; and
- The EU Development Agencies themselves.

A set of summary figures is presented for each of these stakeholders. The figures show how different stakeholders could leverage different financing mechanisms and sources, by using EU aid resources in different ways, to best alleviate the particular constraints they face.

On the top left hand side, each figure lists the most pertinent constraints that each particular stakeholder faces in mobilising more finance for the water sector. On the bottom left hand side, each figure lists the methods of most relevance to that stakeholder for mitigating these constraints, through more effective uses of EU aid and resources. Finally, on the right hand side, each figure lists the most relevant possible sources and mechanisms of finance, which could become potentially available to the stakeholder, once those

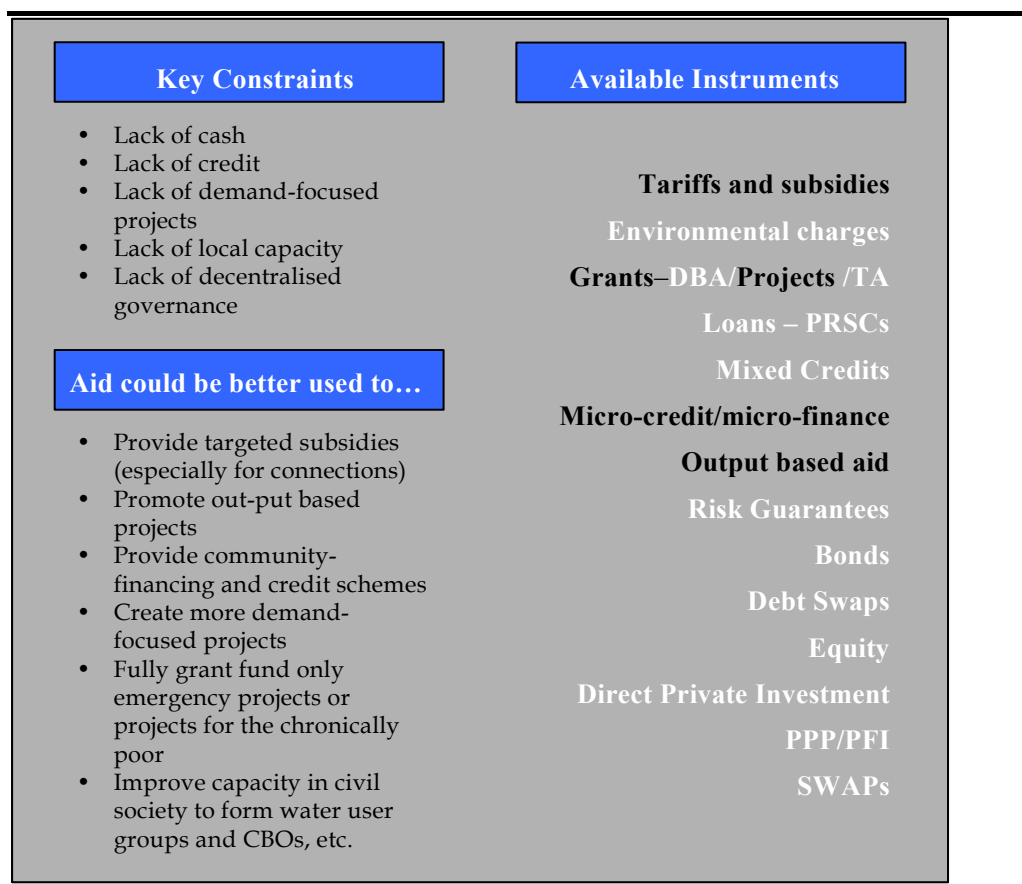
constraints have been mitigated. There is a defined menu of financing sources and mechanisms for all stakeholders, but those of most relevance to each stakeholder are highlighted in bold.

Each figure is accompanied by some explanatory text, and where relevant, some of the World Panel’s proposals are also highlighted as supporting material.

It is hoped that the presentation of findings in this manner pinpoints the “how to” factor, providing a clear signal about how best to target EUWI finance for each type of water sector stakeholder. Although general in nature as presented here, these figures should also be flexible enough to be adapted by each regional component of the EUWI, to help show where EU aid and resources could be used most effectively in each region, for whom, and with what expected outcomes.

### 3.4.2 *Mitigating the constraints to finance for water users*

**Figure 3.1** *Summary of financing issues for water users*



The willingness and ability of domestic water users to generate finance to pay for their water services in a sustainable manner is of critical importance. If there is no revenue stream being generated to cover costs, the network or equipment will break down and need replacing again - aid dependency will continue. If there is no revenue stream apparent in the long run, there will be no interest from those external sources of finance wishing to derive a return on their investments or loans. If users are not paying for the service, they will take less interest in sustaining it themselves.

However, if the focus is on increasing investment in water services to meet the EUWI's goals (the MDG targets), the users in question are likely to be poor. How can they afford to pay? Who would loan money or offer credit to them? How can EU aid and resources best tackle these problems?

*Figure 3.1* suggests that the key constraints to water users accessing more finance cover, commercial, governance, project design and capacity issues. Specifically, they include a lack of access to cash and credit, a lack of a decentralised space within which to manage their affairs autonomously, a lack of well designed demand-focused projects; and a lack of capacity among local user groups to design, manage and implement water and sanitation projects.

Potential ways of helping water users to leverage more of their own and others finance into the sector include through tariff and subsidy reform (allowing them and helping them to pay for the type of project they actually want), grant-based "kick-start" projects where necessary, supporting credit initiatives, and through the use of micro-finance and output based aid initiatives.

The World Panel also draws attention to the need for sustainable cost recovery to be stimulated from water users, via appropriate tariffs (including local cross subsidisation and increasing block tariffs), targeted subsidies, capacity building of civil society, the use of micro-credit and seed capital, and participation in user-managed (demand led) schemes.

But how can the EUWI help achieve this?

EU grant-based aid could be more effectively used to help water users trigger these extra forms of finance through paying for the provision of targeted subsidies (especially for connections); the start up of community-financing and credit schemes; helping to design and create more demand-focused projects; promoting output-based projects; and, importantly, developing the capacity within civil society to form water user groups, CBOs and other local civil society institutions. Full grant funding may only be necessary for emergency projects or projects for the chronically poor in extremely remote areas.

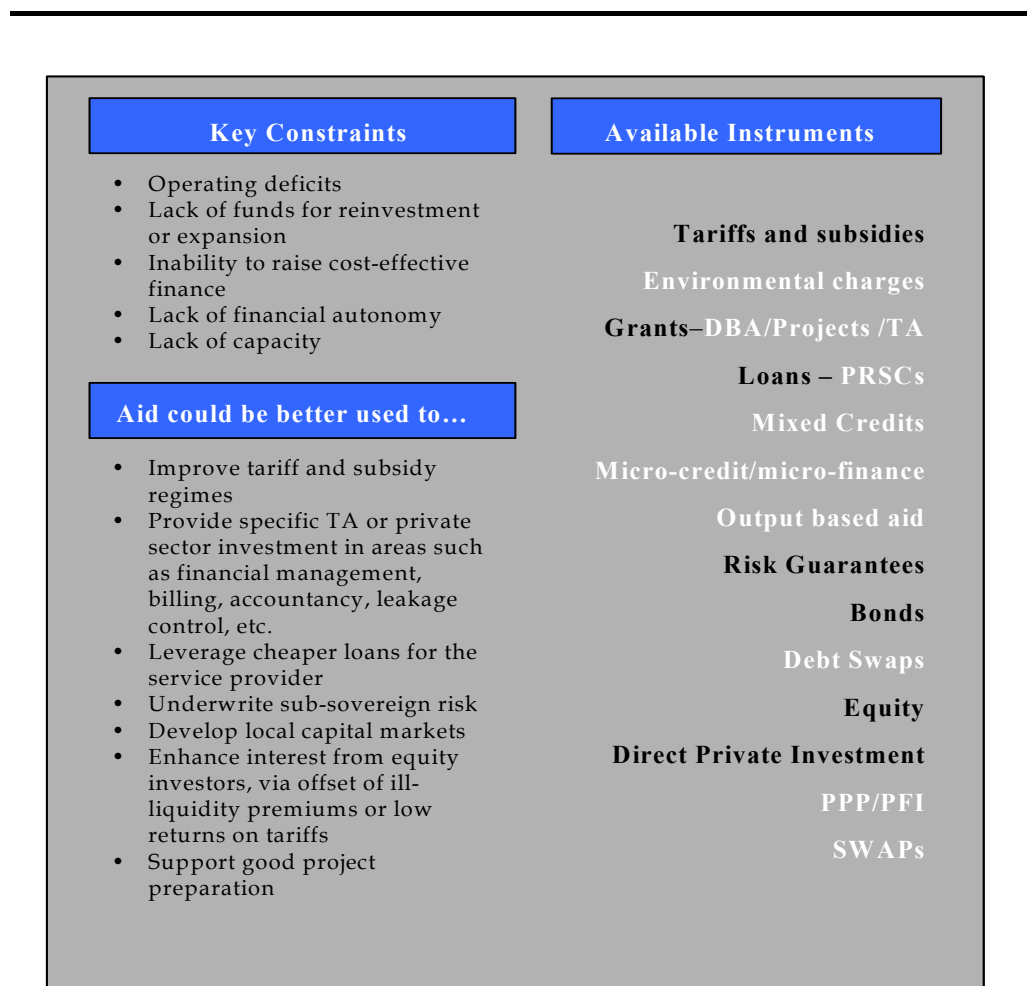
While some EU aid programmes may support such initiatives, they may not be coordinated or targeted toward the most needy countries. For example, there is not a systematic EU wide aid mechanism that provides demand-led support to water users to help them trigger their own or local sources of finance, especially in rural or peri-urban areas (or in lesson learning from successes in this area).

Many EU based research centres and INGOS work extremely effectively in this domain, forming networks of local alliances with domestic NGOs in identifying or delivering demand-led and sustainable water schemes for poor people. Support in their efforts to scale up activities and, importantly, to develop capacity, may be effective areas of focus for harmonised EU aid and resources. While the World Panel advocates the creation of funds in each regional development bank for NGOs to use in order to develop capacity, it may be the case that some existing civil society capacity building programmes from within the EU aid family can be identified, and then replicated or adapted with the support of the EUWI to meet the requirements of water users in each regional component.

### 3.4.3

#### *Mitigating the constraints to finance for water service providers*

Figure 3.2 Summary of financing issues for water service providers



Those countries, which the EUWI’s goals are most focused upon, are the highly indebted poor countries (HIPC’s). Water service providers in these countries are generally going to be public sector agencies with a responsibility for providing water and sanitation services to a regional area or a municipality. They will generally be managed at the sub-sovereign level (unless, perhaps, the water service provider is providing for the capital city). In some cases, with support from their public sector owners, they may have contracted out part of their remit to private sector operators (billing, collections, maintenance tasks for example). Generally, however, the service provider is likely to be over-stretched, under financed and providing as best a service as possible, given very difficult financial conditions. The management mode of the service provider is more likely to be that of short-term crisis mitigation rather than long-term and strategic.

*Figure 3.2* suggests that the key constraints to these kinds of water service providers accessing more finance concern commercial and capacity issues (with governance constraints tending to lie outside of their control). Specifically, these constraints include a lack of day-to-day cash revenue and a wider inability (for commercial or wider governance reasons) to raise cost effective finance. A lack of capacity in finance and strategic management capabilities, rather than technical water issues, may also be a common constraint.

Potential ways of helping water service providers to leverage more finance into the sector include through tariff and subsidy reform (and improved billing and collection procedures) and through stimulating a mixture of finance sources including loans, raising bonds, encouraging equity stakes and direct private investment in their organisations. The use of commercial risk guarantees could also help to attract this finance; though it is unlikely the water service provider would be able to offer much guarantee to a debt provider without wider government help.

The World Panel also draws attention to the plight of water service providers, particularly in relation to its set of proposals at the sub-sovereign level. The Panel proposes more training, partnerships and associations, standardised contracts for private sector participation, benchmarking of their performance and technical assistance in project preparation, to broadly help develop capacity. In relation to the (sub sovereign) commercial constraints facing water sector providers, the Panel suggests a range of options including more secure transfers of central funds, more clearly defined fiscal relationships with Government, better access to long term credit markets, technical assistance for better project development, concessional financing from donors for water projects and the freeing up of more water service provider's operations to be privately financed and managed.

While the boundary between the sub-sovereign and the water service provider is inevitably blurred, it is however clear that EU grant-based aid could be used effectively to help water service providers in a number of ways. By providing various forms of technical assistance or output-based aid in areas of strategic development, price reform, accountancy improvements, customer services and billing and collections (generally corporatising the entity) a gradual change to a more commercially minded organisation could be instigated. A focus on capacity building (via twinning, association forming or focused consultancy inputs) could also be supported. Grant aid could also be used to support changes to the wider financing space within which the service provider operates, for example by helping to identify and negotiate (and provide) affordable loans for the service provider; by underwriting some of the risk of these loans and by exploring how to develop local capital markets to enable the provider to raise more local currency finance.

Similarly, EU grant-aid could be used to enhance interest from external commercial lenders or equity investors in the service provider, by using aid to off set of ill-liquidity premiums or their generally low returns on tariffs; or perhaps to subsidise EU-based finance institutions to provide below market rates for loans the service provider may wish to take on in order to pursue service delivery in poorer parts of its customers base (peri-urban or rural areas, for example), perhaps through the use of institutions such as the Emerging African Infrastructure Fund. Across all of these activities, access to grant-finance facilities and expertise to develop good quality proposals to embark on these changes is also an important area where well-targeted EU aid could play a key role, perhaps via the PIDG's DevCo facility, or within the aegis of the African Water Facility for sub-Saharan Africa or the project Preparation Committee, in the EECCA region, or even via regionally developed mechanisms similar to the World Bank/ TACIS Joint Environment Programmes for environmental infrastructure (See *Annex D*).

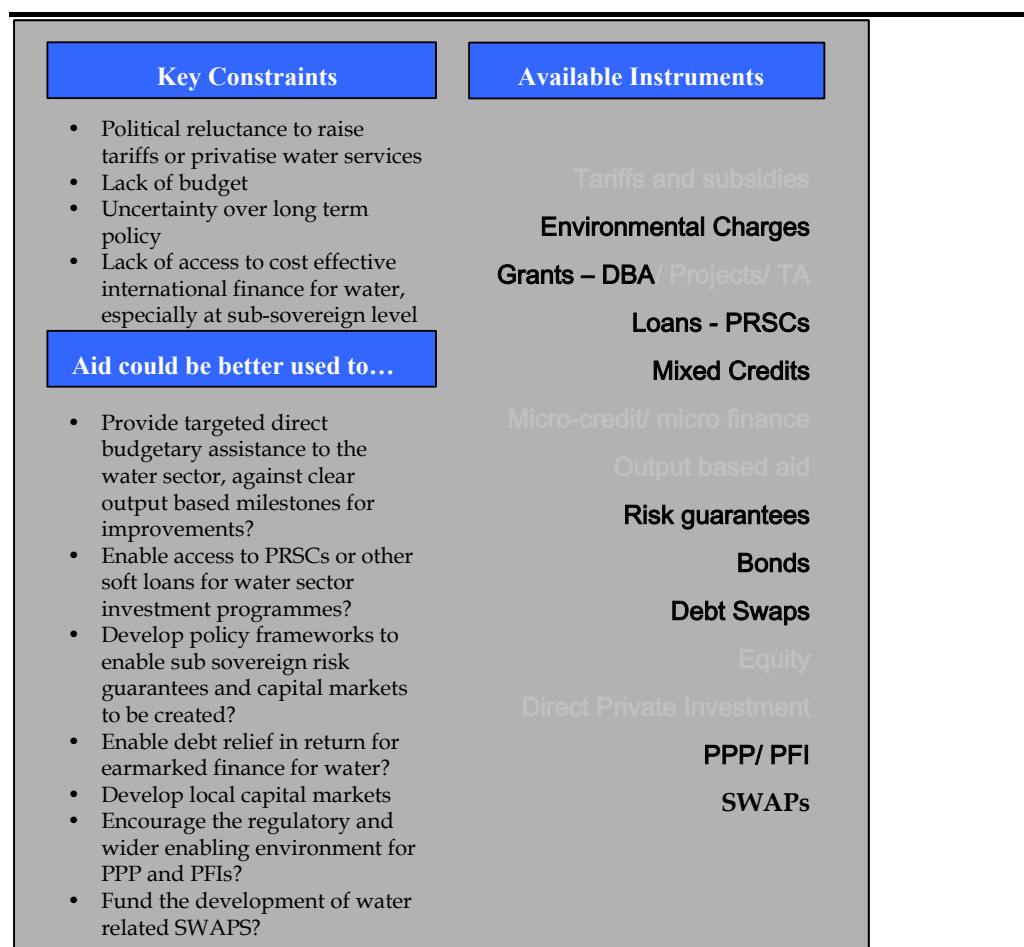
Again, while some EU aid programmes may already support such initiatives, they may not be coordinated or consistently targeted toward those service providers most in need of support in key HIPC countries. The likelihood is also that they may not form part of a systematic EU wide approach to provide support to water service providers to help gradually commercialise their entities, develop good quality projects, or mobilise local or intentional forms of finance at affordable rates. The EU aid family also rarely jointly supports centres of excellence where, for example, service providers can access national (and international) expertise across the range of disciplines required for water sector reform processes and where they can also cross share and access information, experiences and contacts.

Finally, it also becomes clear that while coordination in the aid delivery process is critical to ensure harmony between the development of the potential of water users and water service providers to overcome their constraints and better access finance, to a large extent these programmes can not take place without involving concurrent changes in the wider governance arenas, at the sub sovereign and national levels. It is thus probably in the area of governance reform, at sovereign and sub-sovereign level, where the EUWI should try to exert most influence.

#### 3.4.4

#### *Mitigating the constraints to finance for government*

**Figure 3.3** Summary of financing issues in the wider governance sector



Stakeholders in the wider governance environment include both sovereign (national government) and sub sovereign (local or state government) entities.

Figure 3.3 suggests that the key constraints to Government at both levels accessing more finance for water relate broadly to the issue of minimising the perception of political risk – water governance issues. These are large challenges to overcome and may include a mixture of some or all of the following.

At both sovereign and sub sovereign levels

- A political reluctance to decentralise water responsibilities, to reform tariffs and subsidies or to encourage more involvement from the private sector or private finance;
- Budgetary constraints due to the problem of competing social demands, especially from health (HIV) issues;
- A lack of a long-term strategy or vision for development and investment in the water sector, either as part of or separate to the PRSP process;

- A lack of understanding about how (or reluctance to) adjust policy to better access cost-effective domestic and international finance for water; and
- A lack of capacity within authority to create the right sorts of financing policies; to develop robust designs for financially sustainable water supply projects for the poorest people; and to adjust staff roles and skills from being responsible for service provision to being responsible for regulation and project management and evaluation.

Some issues, particular to the sovereign level may involve a lack of clarity over the fiscal relationship between the centre and state government; a lack of support from the centre to guarantee or provide security on fiscal flows to the sub-sovereign level; a weak or unclear national legal and regulatory structure within which sub-sovereigns can operate their water sectors; an unclear policy lead on issues of private sector participation or the use of private sector finance in water sector activities; a low prioritisation of water sector issues within the national PRSP; and an unclear policy lead on the roles and responsibilities of the public sector, the private sector and civil society groups in the provision of water sector services.

Notwithstanding sub-sovereign variants of the issues mentioned above, some further governance issues particular to the sub-sovereign level may include a lack of capacity within the public sector to act upon the opportunities for attracting a wider range of finance into state government for sectors such as water; a lack of ability to provide adequate financial guarantees; and a higher level of political interference in “local” water issues such as tariffs and subsidies.

However, the table shows that there is a potentially wide range of mechanisms available for national and local government authorities to deploy to improve their governance environments and thus to attract more finance into the water sector. These include:

- The development of financially sustainable tariff and subsidy policies;
- The use of environmental charges to raise finance and change behaviour of large-scale water abstracters and polluters;
- The better use of donor grants, direct budgetary assistance for water and the accessing of soft loans such as PRSCs (which would, of course, be dependant on a PRSP which identified water as a key poverty reduction priority);
- The exploration of the use of certain donor mixed credit or export fund schemes for providing the investment for water projects;
- The development of the “right kinds” of institutional and policy environments conducive to creating local capital markets; and
- Exploring with EU donors the potential for debt swaps for water;

- The use of PFI and sector wide approach programmes for water sector investments.

The guidelines set out in Annex E may provide a useful start point as to the vision of what good water governance should look like, and what the respective roles and responsibilities of the public and private sector and civil society may be.

The World Panel's proposals related to sovereign and sub sovereign entities also broadly echo these suggestions, with perhaps a stronger focus on the development of financial solutions at the sub sovereign level. At the national government level, the Panel usefully suggest a range of plans, indicators, awareness raising and common standards on best practice to increase the prominence and transparent governance of the water sector. At the sub sovereign level, they propose a range of financing mechanisms: *inter alia* the promotion of credit ratings, the promotion of domestic borrowing markets, the encouragement of bond insurance and financial guarantee companies, the creation of joint credit pools, the provision of partial security to sub-sovereign lenders, more use of donor provided technical assistance for project preparation, the use of concessional donor finance for water projects and the use of partial credit guarantees to raise more bonds in local currency.

Hence, in practical terms there could be a wide range of productive activities which well targeted EU aid could be put toward as part of each regional component of the EUWI, to help develop the right kinds of governance framework at the national and sub-national levels. The aim would be for these better-targeted aid packages to stimulate more investments into the water sector from a range of finance sources.

These practical activities may include:

- Capacity building programmes for public sector staff at national and sub-national levels on the changes they should expect in their roles (service providers to regulators) and how to manage that process;
- Practical workshops, skills transfers and centres of excellence for water policy development (for example on introducing water into the PRSP process, on decentralising the water sector, on tariff and subsidy reform, on using the principles of IWRM to underpin water policy, and on issues of aggregation and pro-poor regulatory reform), followed by grant funding and technical assistance for subsequent policy development;
- Technical assistance and training on the introduction of finance issues into water policy and management procedures (for example on the design and implementation of PPP and PFI initiatives for water; on the development of local capital markets or the opportunities that may exist in the

international capital markets for raising finance for the water sector; on financially viable project preparation; on assessing the levels of debt to equity ratios that may be optimal for the public sector authority to sustain for developing sustainable finance strategies for the water sector; on the potential for assessing the credit worthiness of key municipalities and developing risk guarantee mechanisms with the EU donor community for them)

As well as the better and more coordinated use of technical assistance, there may also be plenty of potential in assessing how the EUWI regional components can support governments to make the best use of various infrastructure related or wider multi-donor financing initiatives, either to prepare projects (DevCo, PPC, AWF); to underwrite risk (GuarantCo); to provide concessional loans (*inter alia* EIB, EAIF, AWF, CLIFF); or to reform public financing systems, accountancy procedures and utility price regulations (such as through programmes like FIRST).

### 3.4.5 *Mitigating the constraints to more effective financing facing the EU Aid Agencies*

**Figure 3.4** *Summary of financing issues facing the EU aid family*

Key Constraints	Existing Mechanisms
<ul style="list-style-type: none"> <li>• Low volume of aid committed to the water sector</li> <li>• Aid is not used as effectively as it could be (going to less needy countries and less urgent projects, not really leveraging other forms of finance)</li> <li>• Low levels of coordination or harmonisation between water programmes</li> <li>• Low demand for water from recipient governments</li> <li>• High transaction costs for recipient governments dealing with multiple EU aid donors for water</li> <li>• Poor information transfer between EU aid donors on water</li> </ul>	<ul style="list-style-type: none"> <li>• Agreements for (water sector) aid finance and targets such as Bonn, Monterrey, Cotonou, WSSD MDGs</li> <li>• EUWI secretariat</li> <li>• PIDG and other existing multi donor finance-related mechanisms (DevCo, GuarantCo, EAIF, AWF, PPC, CLIFF, Probarco, PPUE)</li> <li>• PPIAF and other multi-donor funds for TA to analyse related wider policy constraints (tariffs, regulation, decentralisation, benchmarking)</li> <li>• Policy influencers such as EAP task force, NEPAD (AMCOW), WSCC, WWC, GWP, WSP</li> <li>• Effective capacity building programmes within EU aid portfolio including partnerships with the private sector (such as BPD, PAWS, WUP).</li> <li>• DAC database to track disbursement against commitment</li> </ul>
<p><b>EU aid could be made more effective by...</b></p>	
<ul style="list-style-type: none"> <li>• Reaffirming policy and budget commitments to the water sector within the framework of the EUWI</li> <li>• Refocusing water sector aid to be a tool for mitigating the constraints that block other forms of finance flowing into the sector; especially in relation to governance, capacity and project development issues</li> <li>• Using the EUWI as a framework for better harmonising and targeting EU aid flows to water;</li> <li>• Committing water sector aid to support multi-donor mechanisms that influence policy, attract private sector finance or undertake targeted policy development or analyses</li> <li>• Allowing EU aid flows to the water sector to be better monitored and evaluated in relation to EU aid obligations</li> </ul>	

Figure 3.4 indicates that there is also a range of activities that the EU aid family can concentrate on, to improve their effectiveness in tackling the water financing challenge, as part of the EUWI process. These activities broadly fall under the headings of

- Leverage
- Harmonisation
- Awareness raising

### Leverage

As an overriding issue the EU aid family should work on ways to leverage maximum financing from the private sector and users into the water sector. It must be recognised by the EU donors that, at present, the water sector has much lower leverage ratios than other utility sectors in developing countries.<sup>1</sup> A key marker for the EUWI could be that it succeeds in improving the leverage ratio of EU public money to EU private sector investment and user finance. This may be a more important issue to focus on, than lobbying each other to commit more aid to water. The real challenge, the water professionals in the EU aid agencies must face as part of the EUWI, is not how much more aid can they get committed, but how much more effective can they make existing aid commitments become?

### Harmonisation

Parallel to the challenge of aid effectiveness is the issue of transaction costs. Only by harmonising approaches and procedures as well as goals, will the marginal benefit of using extra EU aid for the water sector be clear to recipient governments. More aid with more strands of bureaucracies from each agency is not attractive. Yet the devil, as always, is in the detail. The challenge of harmonising fifteen different bilateral aid approaches and procedures, plus a range of multilateral programmes, may prove much harder for the EU aid family to achieve, than agreeing upon a set of common EUWI goals or criteria for success. This is another key area for EU water sector professionals to focus their time and resources on.

In fact, coordinated funding may be most efficiently organised at a regional level, within each regional component of the initiative taking on the challenge of regional harmonisation. Similar initiatives have already been developed for

(1) For example, in the water sector, between zero and USD 1 of private money is invested for USD 1 of public money, whereas the telecommunications sector has a leverage ratio of USD 2-6 of private money for every USD1 of public money invested, and the electricity sector has an even ratio of around USD 1 of private money invested for each USD 1 of public money.

the EECCA region, following the “Environment for Europe” process. In the case of the EUWI Africa component, for example, AMCOW could be used as a direct interlocutor to help coordinate how to harmonise aid flows from the EU donors and lower transaction costs for recipient governments.

Establishing information channels. External funding is likely to come from a variety of actors, including Member States and multi-laterals but also private operators and financiers. At a regional level again, the EU Water Initiative could serve to act as a single information channel to recipient countries for flows of funds coming from the European Union, and to provide assistance in understanding how to tap into those sources of finance.

Importantly, however, meeting the challenges of creating a better leverage ratio and improved harmonisation does not necessarily require EU agencies to develop a plethora of new initiatives or institutions. Plenty of programmes and frameworks exist within the EU aid architecture already, for the EUWI to graft itself onto.

In terms of the leverage ratio challenge, for example, multi-donor funds or initiatives such as PIDG, PPUE, Proparco, CLIFF, PPC, AWF *et al*, and the range of mechanisms they support are clear partners for the EUWI to influence and channel resources into. Mechanisms for improving the leverage ratio of aid to various sectors or regions exist: the EUWI can be put to work to strengthen and sharpen them from a water sector perspective.

In terms of the harmonisation challenge, a range of policy institutions and fora exist that can be utilised by the EUWI to help guide the coordination process. These include bodies such as the OECD, the GWP, the WSCC, the WSP and regionally specific interlocutors such as AMCOW and the EAP Task Force. The OECD DAC can also be used to ensure more robust tracking, monitoring and evaluation procedures to measure success, based upon the goals of the EUWI.

There is also a range of twinning, public-private partnership or other professional association initiatives that exist within the water sector, which the EUWI can support to bolster the issue of skills transfer and capacity building. These include the BPD component for water, the WUP and the UK PAWS among others. Wider capacity and policy building initiatives that already look into issues such as regulatory policy, tariffs, decentralisation and industry structures for example include funds such as PPIAF. The EUWI could support PPIAF to undertake more work on the kinds of capacity and policy-building issues, which will be needed in particular EUWI regions or countries, if the harmonised aid and the leverage it aims to create, are to be put to best effect.

This report has also shown that there is currently inadequate statistical information on the existing funding of the water sector, future commitments

and estimated needs to meet the Millennium Development Goals or Vision 21 targets. In addition, there is no centralised source of information on EU aid flows to the EUWI regions, constraining the ability to benchmark progress or disseminate results. Further, aid flows could be more effectively coordinated through a wider reconciliation with other non-EU sources, if more information were available. Therefore, additional analysis is required to identify potential overlaps and gaps between assistance programmes carried out by EU Member States and institutions (within the context of the wider donor community), and areas where efficiency gains could be generated from a better coordination of EU aid flows with other aid flows. The OECD DAC database and the resources allocated to it, is the obvious mechanism for the EUWI support in this data collection and analysis process.

### Awareness Raising

A key challenge for water sector professionals in the EU aid agencies is that the demand for a more effective flow of EU aid to the water sector needs to come more strongly from developing countries themselves. It is not really emerging out of the PRSP process to date.

However, the EUWI could help to focus attention among recipient governments on the usefulness of its goals to them.

With better communication, for example, about the EUWI's financing strategy, in particular the desire to obtain a better leverage ratio for water related aid (hopefully stimulating the domestic private sector, local capital markets and external investments as a result); the desire to build capacity in key areas of regulation and utility policy; and an overall desire to reduce transaction costs for recipient countries, the case for water should become more attractive. As a result, EUWI-related activities might start to emerge more prominently in PRSPs than they do at present. <sup>(1)</sup> Additionally, it could also be made clear that additional requests for funding for such EUWI-related activities, especially if featured in the PRSP, would be very well received by the EU donor community. <sup>(2)</sup>

(1) Further, by framing water within the broader and integrated context of sustainable governance, social and economic development, the EUWI could avoid the problem of being perceived to over-stress one sector at the expense of another.

(2) Some participants in the Finance Working Group suggest going further with this point by creating a commitment by members of the EUWI similar to that made by the G8 with regards to the education MDG such that "no country genuinely committed to poverty reduction, good governance and economic reform will be denied the chance to achieve the Millennium Development Goals (for water and sanitation through lack of finance)"