

Mobilizing Market Finance for Water Utilities in Africa

Practitioners' Workshop, Pretoria, South Africa, August 7-9, 2006

This report summarizes outputs from a Practitioners' Workshop on Mobilizing Market Resources from the Domestic Financial Markets for Water Utilities in Africa held in Pretoria, South Africa, in August 2006. The workshop addressed the challenges of accelerating market financing to improve delivery of services in the continent, and ensuring that these investments result in sustainable delivery of services.



Background

The Water and Sanitation Program (WSP), an international partnership for improving water and sanitation sector policies, practices and capacities, co-organized an African practitioners' workshop on 'Market Finance for Water Utilities in Africa' in Pretoria, South Africa, from 7 - 9 August 2006. The workshop focused on two key financing challenges in attaining the Millennium Development Goals (MDGs) on water and sanitation: mobilizing additional funding resources for developing the water sector; and ensuring that these investments result in sustainable delivery of services.

The event brought together approximately 100 participants from 25 countries, including managers of utilities and regulatory bodies in the water sector, as well as key players in the financial sector, including representatives of commercial banks, credit rating agencies, insurers and project development facilities.

The workshop was a joint initiative of the Water and Sanitation Program, Africa (WSP-Africa), the African Development Bank (AfDB), the Department of Water Affairs and Forestry (DWAf) South Africa, the Public Private Infrastructure Advisory Facility (PPIAF), the Water Utility Partnership (WUP) and the World Bank Institute (WBI). The International Financial Corporation (IFC) Municipal Fund also sponsored some participants. The workshop outputs will feed into a WSP global initiative funded by the Department for International



Development (DFID) that aims to unlock the domestic private sector's potential in the delivery of water and sanitation services to the poor.

Current approaches that rely on public funding from governments and donors often fall short on resource mobilization and on ensuring improvement in service delivery. New ways are needed to bridge this financing gap along with sector governance reform and improving the financial viability of utilities, as has been highlighted by reports from important recent panels such as those chaired by Michael Camdessus and Angel Gurría. The workshop was centered on creating a better understanding of the challenges of accelerating market financing to improve delivery of services in Africa.

The workshop program was articulated around three themes: reforms and practical strategies to improve the financial viability of utilities, and lessons learned from transaction experiences for improving bankability and market access for utilities; assessing utility readiness from the perspective of financing institutions and credit rating agencies and measures to improve bankability and access; and reviewing the opportunities of innovative financing and support to facilitate transactions.

Discussions at the workshop were informed by detailed case studies and a utility survey among participating utilities to assess their readiness to access domestic financial markets.

Discussion points

Market finance and utility reform are intertwined

Financial viability is critical for bankability and for accessing private finance. Many successful practical strategies have been adopted by water utilities in Africa to achieve financial viability, as demonstrated by the case studies of the National Water and Sewerage Corporation in Uganda, ONEA in Burkina Faso, SONEDE in Tunis and Johannesburg Water. These strategies have been made possible in the context of institutional and regulatory reforms initiated on the continent. One important tool has been the use of performance contracts between the government and the utility, cascading down to the staff of the utility. These contracts can also help limit potential day-to-day political interference in utility operation.

Access to market finance provides an incentive for both external institutional and regulatory reforms, as well internal management reforms as bankability requires financial viability backed by external reforms that make improved utility management possible. If designed well, market finance can thus be used to leverage sustainable improvements in utility performance.

A need to demonstrate and create room for market transactions

Several examples of market-based transactions on the ground in Africa were presented at the workshop – ranging from working capital to major investments as illustrated by case studies of completed transactions by local governments of Johannesburg and Durban for their investments in water supply, through public-private partnerships by SONESE and SDE from

Senegal and Sulemanzi in South Africa for major infrastructure investments, as well as market finance for working capital mobilized by several utilities present at the workshop. However, there is considerable variation in readiness for market access across utilities, and there was consensus that the best way forward was through actual transactions on the ground.

In this context, however, it is important to recognize that utilities need banks and other support facilities more than the banks need water utilities – despite the fact that interest in the water sector has grown in recent years. The domestic financing institutions (FIs) at the workshop did evince interest in the water sector, but risks are perceived to be high and sometimes difficult to assess. As a result, initial transaction costs can be very high. Thus, to get the domestic FIs interested and actively engaged in the sector, innovative financing instruments and financing of transaction support are essential. The workshop deliberations also suggest that there is often competition to market finance from development banks and donors.

To realize the benefits of market finance for the water sector, development finance needs to crowd in rather than crowd out market finance and facilitate opportunities to make actual transactions happen on the ground to demonstrate 'doability'.

A need to strengthen the 'niche for water supply' in the many instruments and support facilities that are available to facilitate access to market finance

Presentations by financing institutions and development partners at the

workshop suggested that a number of instruments and opportunities are available to facilitate access to market finance for infrastructure.

However, specific attention to water supply has been limited due to the complexities and perceptions of risks associated with the water sector, especially related to governance, and social and environmental issues. Once they reach a state of near-readiness, utilities should try to access capital markets and devise strategies to market themselves to financial institutions.

The deliberations thus focused on creating a 'niche for water' in existing instruments and facilities.

Specific areas of support that were presented and discussed included:

- various facilities under the Private Infrastructure Development Group (PIDG)
- IFC and European Investment Bank (EIB)
- innovative funding support from the Africa Water Facility at the AfDB and Global Partnership on Output-based Aid
- assessments by credit rating agencies with possible directions for external and/ or internal reforms, as well as credit enhancement structuring to improve bankability
- partial guarantees from the United States Agency for International Development (USAID's) program on Development Credit Authority and Africa Trade Insurance.

A review of the PPIAF's project support facilities also suggested that many opportunities for transaction support were available.

Key Messages

Market finance and utility reform are closely intertwined

- Financial viability is attainable in the water sector. Practical strategies for financial viability were presented by the National Water and Sewerage Corporation (Uganda), Office National de l'Eau et de l'Assainissement (ONEA) [National Office of Water and Drainage] (Burkina Faso), Société Nationale d'Exploitation et de Distribution des Eaux (SONEDE) (Tunis) and Johannesburg Water.
- Financial viability is imperative for accessing private finance and turning investments in utilities into bankable opportunities. Bankability requires both external institutional and regulatory reforms as well as internal reforms.
- Market finance can be used to attain sustainable improvements in utility performance by creating the right incentives for utilities to reform. The potential of market transactions will be substantially enhanced by a predictable, dependable and regular intergovernmental transfer system coupled with performance benchmarks.

A need to demonstrate and create room for market transactions

- Market-based transactions by water utilities in Africa have generally taken place for working capital or major investments. Examples include the Durban and Johannesburg municipalities, SONES/SDE (Senegal) and Sulemanzi (South Africa). The workshop deliberations suggested the need to focus on developing a middle range of market transactions for operational improvements that will also result in net revenue increases.
- Risks are perceived to be high in the water sector and sometimes difficult to assess. It is therefore important to identify them to better understand and mitigate them. Further, there is considerable variation in readiness for market access across utilities. This was apparent from the results of the utility questionnaire and the discussions at the workshop that revealed the following: a) Utilities are not the only bodies that borrow – asset-owner companies, municipal governments and private partners are also looking to

access market finance; b) the prevalence of balance sheets as well as project structures for lending; c) the use of pooled structures, especially for direct market access; d) the need for credit enhancements due to high perceived risks; and e) collateral and tenor are key issues in water sector lending.

- Development finance and overseas development assistance (ODA) need to crowd in rather than crowd out market finance and need to facilitate opportunities that exist to enable market transactions and demonstrate 'doability'.

A need to strengthen the 'niche for water supply' in the many instruments and support facilities that are available to facilitate access to market finance

- Several opportunities for supporting access to market finance for infrastructure exist and were presented at the workshop. A 'niche for water' is needed to enable utilities and domestic financial institutions to access this finance.
- Credit rating enables an independent assessment of potential borrowers and related project/ transaction structures and provides a process of self-assessment. Credit rating also creates a better understanding of risks for both utilities and financiers and helps to determine the nature of credit enhancements needed.
- Innovative financing instruments and programs exist to support access to markets (e.g. Output Based Aid (OBA), Development Credit Authority (DCA), African Water Facility (AWF), African Trade Insurance Agency (ATI), European Investment Bank (EIB) through credit enhancement. To access these, specialized country-based support is necessary as transaction costs are high.
- A recent PPIAF review suggests that a variety of project development support systems are available for different stages in project development cycle; however their use requires an on-the-ground 'honest broker'. IFC also supports project development, but a special emphasis on water supply will be needed for utilities to access this support.

Recommendations

All the organizing partners agreed to contribute towards the workshop recommendations by focusing on:

- continuing the dialogue process started at the workshop;
- knowledge management and capacity building;
- developing demand-led transactions on the ground;
- facilitating national/ regional benchmarking and credit rating processes;
- supporting experience sharing

‘Getting the basics right’ is critical to ensuring external reforms and to identifying an appropriate role for ODA

Basics need to be right for utilities to access finance in the domestic financial markets, both in terms of the required institutional and regulatory reforms in the water sector, and for the framework for development finance so that it crowds in, and not out, local market resources, particularly to provide the initial impetus to reforms. Many utilities in the near future will continue to require intergovernmental transfers and subsidies, but the predictability, dependability and regularity of such transfers will be critical to establish bankability and to access capital markets.

Workshop participants agreed to the following actions by partners: AfDB to facilitate and coordinate responses from the development partners; DWAF to support developing an enabling environment in South Africa; WSP and AfDB to support the work with interested countries to create a more enabling environment; and PPIAF to support these partners as water and sanitation continue to be key priorities in Africa.

The process has to be supported by country processes and the development of actual transactions

In order to attract market finance for the water sector, development of transactions is critical. Some utilities, particularly in South Africa, are already well-prepared and provide bankable opportunities. The range of transaction opportunities need to be pursued with a particular focus on transactions for operational improvements with a good revenue model. However, in most cases, efforts will be geared toward starting the dialogue process between water sector actors and domestic financing institutions at the country level. The support of development partners would be a valuable contribution to this process.

WSP indicated its willingness to take the lead in working with countries to support 'demand-led transactions on the ground'. AfDB will also work with governments and utilities to help utilities access market finance using tools such as sub-sovereign lending and guarantees. DWAF agreed to support pilot projects in South Africa and the Southern African Development Community (SADC). In this, however, it is important that utilities own and drive the process by obtaining a credit rating and instituting more transparent processes.

A movement toward benchmarking and credit rating is an important step toward improving bankability and transaction development

There was a strong consensus on the need to refine and consolidate the utility questionnaire used for assessing

the utility's creditworthiness into a sustainable benchmarking process mimicking credit rating agencies through a 'shadow' rating.

In addition, direct utility engagement with credit rating agencies would improve self-assessment and identify areas of reform for market access as well as the nature of credit enhancements.

WSP and AfDB, with support from the Water Utility Partnership (WUP), showed willingness to facilitate regional and national benchmarking processes as well as to enable demand-based credit assessment in selected utilities leading to shadow rating; they will also explore possible linkages between benchmarking and actual transactions and credit enhancement where necessary.

DWAF indicated willingness to support sharing through networks and work with other partners to take this initiative forward to the African Ministerial Council on Water (AMCOW.)

There is a need to facilitate a better understanding of the market and potential opportunities among utilities and bankers through greater experience sharing and knowledge management

The participants recognized that there is a wealth of information and experiences that they can draw from, and that there is need to build the capacity of all actors. Three actions were particularly emphasized: opportunities for experience sharing and South-South learning, training and awareness-raising, and the need to develop 'How To' guides. WBI indicated its willingness

to take the lead in facilitating learning and capacity building, and helping with the dissemination of case studies and lessons learned in collaboration with other partners. PPIAF also agreed to share the findings of an

analysis of project development and credit enhancement facilities that it is currently undertaking. WUP indicated its willingness to contribute by providing a platform for interaction with utilities throughout Africa.

All partners and participants strongly recommended that the utilities, financing institutions and development partners convene again to take stock of progress and share emerging lessons from implementing these recommendations.



Action points

‘Getting the Basics Right’ – within utilities, the water sector and ODA

- Utilities need to introduce internal management strategies to improve financial viability by:
 - improving revenue collection systems;
 - minimizing no-revenue water;
 - ensuring competent management and staffing;
 - introducing management information systems (MIS) and financial information systems;
 - improving customer relations.
To facilitate these actions, a proper physical database interlinked with the financial systems needs to be created.
- Governments need to support the ability of utilities to access market finance by:
 - introducing appropriate institutional and regulatory frameworks that support utility autonomy;
 - making regular external audits mandatory;
 - cleaning up balance sheets, if necessary through debt/equity swap or working with donors to convert the past unsustainable debts to grants;
 - increasing predictability of transfers;
 - providing incentives to address environmental risk.
- ODA needs to be used to crowd in market resources, and, not crowd them out. ODA needs to also provide an impetus to reforms to get the basics right in countries.

Initiate Country Processes for Reforms and Transactions

- Identify and support 'cherry picked' initial transactions with a focus on transactions for operational improvements with a good revenue model for demonstration and lesson learning.

- When developing transactions, explore appropriate use of existing ODA facilities to leverage innovative financing instruments, project development assistance and credit enhancements or partial guarantees.
- Support utilities to market themselves to the financial sector through regular 'road-shows' where utilities can report their financial status, propose ideas and develop relationships with the financial sector.

Initiate Regional Processes for Reforms and Benchmarking

- Develop processes to create comparative information and industry awareness by deepening the benchmarking exercises to foster a better understanding among utilities of what constitutes 'creditworthiness' and 'bankability'.
- Initiate the movement toward credit rating to enable utilities to conduct facilitated self-assessments, to identify areas for reform and to create interest within the financial sector.
- Engage with credit rating agencies to refine methodologies and work with select utilities to support self-assessment, to identify areas for reform and to determine credit enhancement needs.

Capacity Building through Knowledge Management and Experience Sharing

- Enable knowledge management through 'How To' guides for utilities and FIs on market transactions for water, and raise awareness and understanding within the banking sector about the water sector and on available ODA support programs/ facilities.
- Create opportunities for experience sharing and South-South learning for utilities in Africa and other regions.

WSP Publications on Sector Finance and PRSPs in Africa

WSS Component in Poverty Reduction Strategy Papers

- *Water Supply and Sanitation in Poverty Strategy Papers in Sub-Saharan Africa: Developing a Benchmarking Review and Exploring the Way Forward.* By Meera Mehta & Thomas Fugelsnes. 2003.
- *Water and Sanitation in PRSP Initiatives: A Desk Review of the Emerging Experience in Sub-Saharan Africa (SSA).* By Meera Mehta. 2002.
- *Factors behind the Poor Integration of the Water and Sanitation Sector in PRSPs in Sub-Saharan Africa-Lessons from Uganda, Malawi and Zambia – Full report.* By Tim Williamson, Tom Slaymaker & Peter Newborne. 2004.

Country Finance and Resource Flows Assessments and Investment/Financing Strategies

- *Sector Finance and Resource Flows for Water Supply: A pilot application for Kenya.* By Meera Mehta & John Ondari. 2004.
- *Strengthening Budget Mechanisms for Sanitation in Uganda.* By Mike Thomson. 2004.
- *Water Supply and Sanitation Sector Finance and Resource Flow Assessment: Zambia.* By Dennis Chiwele. 2004.
- *Ethiopia Water Supply Sector Resource Flows Assessment.* WSP-Africa. 2004.

Global and Regional Reviews of Country Experiences and Financing Mechanisms

- *Meeting the Financing Challenge for Water Supply and Sanitation.* By Meera Mehta. 2004.
- *Financing the Millennium Development Goals for Water and Sanitation: What Will It Take?* Meera Mehta, Thomas Fugelsnes & Kameel Virjee. 2004.
- *The Challenge of Financing Sanitation for Meeting the Millennium Development Goals.* By Meera Mehta & Andreas Knapp. 2004.
- *The Governance and Financing of Water and Sanitation in Ethiopia, Kenya and South Africa: A Cross-country Synthesis.* By David Savage. 2003.
- *Financing Small Water Supply and Sanitation Services Providers: Exploring the Micro-Finance Option in Sub-Saharan Africa.* Meera Mehta & Kameel Virjee. 2004.
- *Water and Sanitation in Social Funds: A Rapid Assessment in Sub-Saharan Africa.* By Gerry Garvey. 2003.



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