International Conference on Financing Water and Sanitation Services

**

Innovative Options in the Public and Private financing of Urban systems: Moving Beyond the Public-Private Debate

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Inter-American Development Bank

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Discussion Points

- MDGs and The Finance Challenge
- Financial Sustainability - Closing the Revenue Gap
- Use of Subsidies
- The Importance of Long Term Financing to WSS
- Managing Financial and Governance Risks – A Framework For Allocating Risks, Public or Private
- Some Innovative Hybrid Financing Models
The MDGs – A Startling Reminder of the Financing Challenge Ahead

- Halve by 2015 the proportion of people without sustainable access to safe drinking water

- Halve by 2015 the proportion of people without access to basic sanitation

- Translates into a doubling of investment needs from $15 billion to $30 billion per year for water supply & sanitation alone (as part of 180B for all water)
The Finance Challenge - An Uphill Battle for Developing World and Infant Sectors

<table>
<thead>
<tr>
<th>Current Coverage</th>
<th>Years to Full Coverage at Annual Growth Rates</th>
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<tr>
<td></td>
<td>5%</td>
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<tr>
<td>35%</td>
<td>30 years</td>
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<td>50%</td>
<td>20 years</td>
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<tr>
<td>75%</td>
<td>8 years</td>
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<td>100%</td>
<td>Less Than One Year</td>
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Assumes 1.3 population growth rate.
The Market: The WSS Poses Special Challenges

- Limited number of developers/operators
- Generally low margins
- Complexity and risks in the contractual and regulatory framework
- Sub-sovereign risk
- Limited pool of bankable projects (size, condition, readiness)

Size of population centre

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Attractiveness

- high potential for private financing
- medium potential for private financing
- low potential for private financing
- Need for public investment
- Household & micro-financing

Most | More | Medium | Less | Least
Investments Can Only Expand with Improved Sector Performance

- Low service coverage in the backdrop of increasing demand
- Poor operating performance = high losses
- Tariffs Not Recovering Costs
- Low capacity to service existing debt
- Inherently inefficient systems
- Traditional financing constraints – scarce resources with lingering subsidy mentality
- Non-existent or ineffective regulatory framework
Going Forward: Long-Term Sustainability: A Must

- Improve Sector Performance – Closing the Revenue Gap is Key

- With Decentralization, There is a Need to Bring in Local Governments as Key Stakeholders in the Financing of Water Investments – (ie. contributors of equity, guarantors, or direct borrowers)

- Cost Recovery Critical: *But At A Realistic Pace*

- The Use of Subsidies Should be Transparent and Primarily Aimed at Serving Poor Communities.

- Make Use of All Sources of Financing – Public or Private and Create Framework Where Risks Are Properly Allocated and Bound By Enforceable Contracts.
Some Fundamental Premises

- There is a Definite Cost Incurred in Delivering water to Communities.
- In Most Cases, Users Are Not Paying For the Cost of Water, But For the Service of Delivering It.
- So, You Either Provide a Service or Not.
- The Options on Who Pays for that Service are Limited.
- The More the Willingness of Users to Pay, the More Financing Options that Exist.
- With Greater Financing Options, the More Service Can Be Expanded to Needy Communities!
- But social considerations should be taken into account
Closing the Revenue Cycle

- Only if sustainable cashflows, investments for expanding services can be attracted

- Only few choices to finance investments:
  
  ✓ Tariffs (consumers)
  ✓ Taxes (tax payers)
  ✓ Private capital flow – *limited extend*
  ✓ Bilateral and multilateral aid – *limited extend*
What To do?

- Commercial approach/financial discipline
- Focus on needs of the water company
- Cost Recovery Critical: *But At A Realistic Pace*
- Improve creditworthiness through:
  - agreed programme of tariff increases, taking into account social considerations
  - clear / predictable allocation from central/local tax revenues
  - improved operational management/collections

Predictable cash flow ⇒ secure debt service ⇒ investment loan ⇒ better services
But …Cost Recovery Means Different Things to Different People!

- **What it Is Not** – Recovering Just Some Explicit Costs, But Not Others (Subsidized Pricing)

- **What it Can Be in Certain Circumstances** – Recovering All Explicit Cash Commitments (Internal Cash Flow Pricing)

- **What it Should Be** – Recovering Both Explicit and Implicit Costs Plus Earn A Fair Return on Invested Capital (Full Cost Recovery Pricing)

- **But the issue is** the Path of Reaching Cost Recovery
At the Root of the Misunderstanding
Explicit Versus Implicit Charges

<table>
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<th>Explicit Charges</th>
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<tr>
<td>O&amp;M</td>
<td>Recovery of Investment Costs</td>
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<tr>
<td>Principal &amp; Interest</td>
<td>Currency Risk</td>
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<td>Payments On Debt</td>
<td>Water Resources</td>
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<tr>
<td></td>
<td>O&amp;M Not Done</td>
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<tr>
<td></td>
<td>Bad Debts</td>
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<td></td>
<td>Environmental Profits</td>
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Cost Recovery Critical: *But At A Realistic Pace ...And*

- Subsidies Can Be Utilized to Bridge a Finance Gap

- Primarily, In Cases Where Affordability is at Issue and For Poor Communities

- And Yes for Targeted Subsidies:
  - For Connections
  - For Usage Charges

- And subsidy disbursed on actual service delivered to population, and/or improvement of quality / specific benchmarks
Introducing public subsidies into PSP: various possible approaches

- Traditional “input-based” public co-financing: Introducing public subsidies into PSP: various possible approaches
  - subsidize the cost of specific civil works
  - reduce risk profile of operator (shared with Government)
  - distort incentives of operator: disbursement not based on performance, lack of flexibility in investment decisions.

- Complement automatically users’ revenues with subsidy payment:
  - no incentives for delivering services or improving performance
  - potential criticism of “financing private profits”

- Introducing an Output - Based -Aid (OBA) subsidy scheme:
  - subsidy disbursed on actual service delivered to population, and/or improvement of quality / specific benchmarks
  - maintain risk profile + payment based on benefits for population
Contrasting Approaches

**Input-Based Approach**

- **Inputs**
  - (e.g., power plants, schools, etc)
- **Service Provider**
- **Outputs**
- **Users**

**Private Finance**

**Public Funding**

**User-Fees**
(when appropriate)

**Output-Based Approach**

- **Inputs**
  - (e.g., power plants, schools, etc)
- **Service Provider**
- **Outputs**
- **Users**

**Private Finance**

**Public Funding**

Service provider mobilizes private financing

Public funding tied to service delivery
OBA Subsidies – Some Applications

- **OBA subsidy for coverage expansion:**
  - lump payment for each new connection in poor areas

- **OBA subsidy for tariff transition:**
  - support gradual tariff increase to cost-recovering level
  - payment based on service delivered (quality parameter, collection rate) over a limited period

- **OBA subsidy for consumption:**
  - Subsidize minimum consumption for poor households

- **OBA subsidy for wastewater treatment:**
  - subsidy based on amount of pollution removed
The Importance of Long-Term Finance to Water Infrastructure

- Public Sources of Debt Finance Are Limited – We Must Look to Private Sources of Finance.

- Subsidies Are Even More Limited and Cannot Be Relied on to Establish and Maintain Creditworthiness, thus Constraining Commercial Lending.

- Used Prudently Debt Can Allow For a Substantial Leveraging in Order to Expand Coverage.

- However, To Make Use of Favorable Financing Leverage, Returns Must Exceed the Cost of Financing.
Managing Financial Risks
Risks Related to Implementation and Financing of Water Supply Projects

- **System Design & Planning** - Developing Appropriate Investment Program
- **Construction Risk** - Timely Completion of Constructing According to Design Standards
- **Operation & Commercial Risks** - Efficient operation and Management of Water Utility Business
- **Regulatory Risks** - Ensuring efficient tariff levels and quality standards. Regulatory framework not implemented
- **Financing** - Securing Required Equity and Investment Financing to Achieve Investment Goal
- **Credit Risks** – Ensuring timely debt servicing of loans
- **Devaluation/Currency Risks** – Guarding against catastrophic Impacts due to major devaluations and macro instability. Dollar debt and local currency earnings
- **Payment/performance risk.** Government fails to pay amounts due
- **Sub-sovereign risk.** Water investments are often at the sub-sovereign level
- **“Affordability risk”.** Private operators and consumers will not do it all role of public investments and subsidies
- **Other Risks**, such as Political, Terrorism, Force Majeure
Attributes of a Sustainable Framework - Public or Private

- Roles Must Be Clearly Defined and Incentives Must Be Internally Consistent – When in Conflict, the Financial Trade-Offs Must be Explicit.
- Risks Should Be Allocated to the Party That is Most Capable of Managing Such Risks.
- Third-Party Agreements Should be Utilized to Hold Responsible Parties Accountable and to Convert Implicit Charges to Explicit Ones.
- Agreements Should be Arms-Length and Enforceable.
- There Must be an Appropriate Balance of Power – No One Party Should Have Overwhelming Authority.
- Should Seek to Develop Institutions to their Natural End.
Effect of Allocating Risks

In Many Cases Today!

Where to Go!

- National Govt.
- Local Govts.
- Private Sector
- Banks

PDAMs

National Govt.

Private Sector

Local Govts.

Banks

PDAMs
Towards a Sustainable Fund Channeling and Governance Framework

- MOF
- Regulator
- Banks
- LGU
- Utilities
- Private Firms

- MOF - FX Risks
- Banks - Intermediaries
- Utilities - Borrower
- LGU-Guarantor
- Private Firms
- Regulator

Bound by Enforceable Legal Agreements With Recourse for Non-Performance
The public-private dichotomy is a bit false

✓ “public” service providers at a minimum use private suppliers and often outsource many functions
✓ “private” service providers rely on public support (tax holidays, subsidies) and are always subject to some form of public regulation
✓ The focus therefore, should be on: (a) “efficient” public-private partnerships, not on ideological debates; and (b) on who can deliver efficient quality WSS services at lowest cost to the poor.
An Evolving Model for Water Service Delivery

Cost Recovery Critical
But At A Realistic Pace

Targeted Subsidies OK
- For Connections
- For Usage Charges

World Bank Group Combine Instruments
- IBRD/IDA Loans, Credits and Guarantees
- IFC Loans and Investments
- MIGA Guarantees

Engagement Anywhere Along the Spectrum
Unbundling Finance And Management - Looking at Sustainable Hybrid Solutions

- Management
- Finance

- Public
- Private

- Municipal Department
- Corporatized Muni. Service
- Operating Company plc
- Mixed Company

- Management Contracts
- Leases/Affermage
- BOTs
- Concessions
- Divestitures
Some Examples of Hybrid Approaches

Design Build Lease (DBL)

**Characteristics**

1. Public long-term debt channeled through banks
2. MOF takes up FX Risks for a premium
3. Bank On-lend to local governments
4. LGUs lease out construction and O&M to private sector
5. Private sponsor contribute equity portion
6. Lease fee to LGU covers debt service
7. Loan to LGU is secured by fiscal allocation
8. Bid on Lowest average tariff or highest equity contribution

**Most Applicable**

1. For Greenfield investments
2. Resistance on existing water utility
3. Decentralized local governments with capacity to borrow
4. Smaller towns which do not attract private project finance
5. Private sponsor willing to contribute equity
6. Cost recovery tariffs
Some Examples of Hybrid Approaches

Output Based Aid to Extend Coverage

**Characteristics**

1. IFIs/Donors lend or grant funds to central government
2. Central government utilized funds to subsidize investment
   Cost for extending coverage to poor communities
3. Central government enters into agreement with
   private operator to reimburse cost based on connections
   made.
4. Private operator finances other investment and
   operating costs on its own on cost recovery basis
5. Tariffs set to recover all costs except subsidy portion

**Most Applicable**

1. High connection cost to reach outlying areas
2. Poor communities unable to pay for connection
3. Cost recovery tariffs can sustain O&M and returns
   investment from private operators
Some Examples of Hybrid Approaches

Bulk Water BOT with Amalgamation

**Characteristics**

1. IFIs/Donors lend to public utilities for rehabilitation and extension
2. Private financed BOT with private operator with back-to-back agreements from utilities
3. Possible also private concessions to manage utilities, but as separate autonomous entities
4. Each utility would have separate tariffs based on own cost structure
5. Bid however done for all activities under a cluster approach
6. Private equity and either public or private debt depending on availability

**Most Applicable**

1. Regional water source needed
2. Economies gained by clustering smaller less attractive utilities
3. Private long term debt unavailable
4. Amalgamation provides sufficient market to attract equity interest
5. No threat to autonomy of local govt.
Some Examples of Hybrid Approaches

**Affermage (Lease) with Public Debt Finance**

**Characteristics**
1. IFIs/Donors lend to public utilities for rehabilitation and extension
2. Private bid to rehabilitate network and operate it
3. Revenue sharing agreement between Utility and operator
4. Bid on revenue sharing

**Most Applicable**
1. High cost recovery risk for private operator but great need to improve performance
2. No private debt markets
Some Examples of Hybrid Approaches

Workout and Rehabilitation of Failing Utility

Characteristics

1. Tri-Partite Agreement Between MOF, Local Government and Utility on Financial Recovery Program
2. MOF Reschedules Debt, LGU assumes Financial Commitments for Equity and Tariff Increases
3. Utility Adheres to Performance Improvement Program With Quarterly Monitoring
4. Lending Resumes Upon Fulfillment of Agreed Actions with Local Government Guaranteeing Repayment By Utility With Fiscal Transfer as Security
5. Can be Turned Over to Private Operator as in Affermage

Most Applicable

1. Failing Utility of Sector with Significant losses
2. No record of Creditworthiness
3. New Responsibilities for Local Governments
What is the Market for Direct Sub-Sovereign Lending?

- Credit-worthy or nearly credit worthy sub-sovereigns
- Pooled investments

- Crowding out private investment?
- Preparing utilities for private investment?
- Strengthening public sector institutions?

- Instilling market disciplines.
- Preparing for private partnerships.
- Strengthening local government.

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Recapping (1)

- The Water Sector is Facing an Uphill Battle to Expand Coverage.
- The Debate is Not Between Public or Private, But Improving Sector Performance and efficient quality service delivery to the poor at lowest cost
- There is No Magic Solution! Cost Recovery is critical and Should Be the Foundation to A Sustainable Tariff Policy but At Realistic Pace
- Targeted Subsidies OK
  - For Connections
  - For Usage Charges
- If Utilized Prudently targeted subsidies and Long-Term Financing Can Contribute Significantly Towards Expanding Investments and service delivery
- Public funding to shift from input based to output based financing
Recapping (2)

- Mobilizing balanced mix of public and private funding sources – more innovative use of public funds and subsidies
- Powered by sustained cashflows instead of taxes
- Private funding to increasingly comprise local currency alternatives
- Make PPI contracts "pro-poor".
- A Fund Channeling and Governance Framework Based on the Appropriate Allocation of Risks and Third Party Agreements is the Mechanism Needed to Align Incentives and Improve Governance
- Partial Risk and Partial Credit Guarantees
- IFC loan and Guarantees
- MIGA instruments
Thank you