Experience and opportunities for commercial financing in Kenya’s WASH sector

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This paper highlights the process, successes, and challenges of commercial financing for WASH and identifies lessons for moving forward with continued commercial financing in Kenya. The paper is based on a review of the experience of the USAID’s Sustainable Water and Sanitation in Africa (SUWASA) program which ran from 2010 to 2015, and which has been succeeded by the new USAID Water Sanitation and Hygiene Finance (WASHFIN) program designed to enhance access to commercial financing. The paper shows how commercial financing has and continues to build on accomplishments of the Kenyan government in advancing sector reforms in the context of devolution and decentralization.

Decades of sector reforms and a new constitution set the stage for SUWASA
Kenya has made steady progress undertaking sector reforms since the 1990s, emphasizing governance and equitable and sustainable service delivery. These reforms, which were crucial to enabling access to commercial financing, were well underway when the 2002 Water Act was enacted. The Act further advanced the reform agenda culminating in the following critical reforms:

- Separation of water resource management and development from service delivery;
- Creation of autonomous Water Service Providers (WSPs) incorporated under the Companies Act that are responsible for operation and maintenance of water and sanitation infrastructure, which was developed and owned by Water Service Boards to ring fence water revenues; and
- Creation of an independent Water Services Regulatory Board (WASREB), and the Water Services Trust Fund (now Water Sector Trust Fund [WSTF]).

This period of reforms helped to instill a commercial mindset in WSPs, which the World Bank’s Water and Sanitation Program built on through microfinance pilots and commercial borrowing efforts. The Bank support further enhanced this approach by establishing a regulatory performance index and conducting shadow credit ratings to establish creditworthiness. These tools gave both WSPs and lenders an objective basis to assess performance and risk. Kenya signed its new constitution in August 2010 which established a system of decentralized government and devolved service delivery, including water and sanitation, which was enshrined as a basic right. These reform efforts culminated in the achievement of the water Millennium Development Goal (MDG) in Kenya. These reforms and achievements laid a strong foundation for the enhancement of commercial financing in the sector, which the SUWASA program built upon.

USAID sustainable water and sanitation in Africa (SUWASA)
The SUWASA program in Kenya aimed to promote market finance for bankable utility investments, including supporting WSPs in developing commercially viable projects, and assisting banks with product development for the water sector. Traditionally, grants and concessionary loans from development partners have funded the sector. Estimates suggest that, on average, up to 60% of WASH funding in Kenya comes from donors and the remainder from the public purse with minor contributions from tariffs and households.
A key objective of SUWASA was to contribute to expanding and strengthening the flow of commercial financing to the sector. This would not only increase investment, but also contribute to improving WSP performance as commercially viable entities by instilling the governance, consumer focus, and performance discipline necessary for commercial borrowing. SUWASA therefore addressed some fundamental challenges among them, lack of creditworthiness; limited interest in commercial financing due to incentives tied to a reliance on public sources; limited capacity to prepare commercially viable projects; and poor perception of WSPs by commercial banks who had limited understanding of their structure and operation.

SUWASA worked with WSPs to identify viable projects and prepare proper documentation for commercial bank interest. SUWASA also worked with commercial banks to improve their understanding and ability to serve WSPs. As such, SUWASA can be considered a precursor to present day discussions on blending public and private finance to close the financing gap.

The process of commercial financing
The SUWASA activity began with a pilot in Kisumu that raised KES 20.1 million (USD 245,863) to extend piped infrastructure, benefitting 8,975 people in an informal settlement. The success of this pilot led to identification of other WSPs for assistance, based on five key criteria namely sufficiency of water sources, ability to meet operating and maintenance costs, creditworthiness, strength of governance and management commitment, and the financial viability of proposed projects. Eight WSPs were subsequently selected: Kisumu, Embu, Thika, Meru, Muranga South, Muranga, Nyeri, and Mathira.

Providing technical assistance
SUWASA supported each WSP to prioritize a pipeline of projects focusing on financial viability, potential for getting subsidies, increase in connections and water capacity, contribution to WSP income, and prospect of a quick turnaround to repay debt. Once the projects were agreed upon, SUWASA assisted the WSPs in the following areas: undertaking market assessments focusing on household willingness and ability to pay; building capacity in how to engage communities and households to get their buy-in; assessing the debt capacity of the WSP to ensure creditworthiness; developing financial models to ensure loan repayment; analyzing the impact of any subsidies or credit enhancements on the model; developing a project implementation plan; and developing a final proposal for submission to commercial banks.

Obtaining financing
In addition to supporting WSPs through this process, SUWASA was also involved in identifying sources of finance. Three Kenyan commercial banks (Sidian Bank, KCB Bank, and Housing Finance Bank) were selected based on their experience in the water sector, and ability to complete the process to secure a Development Credit Authority (DCA) partial credit guarantee agreement with USAID, which demonstrated an understanding of the risks involved, and a commitment to have the tools in place to mitigate those risks. SUWASA also provided capacity-building support to the banking sector to build understanding of the WSP market and in developing loan products specific to the WASH sector. SUWASA also supported an introduction to the DCA guarantee for banks that lacked one.

As part of the loan application process, SUWASA linked WSPs with the banks, and played a backstopping role in transaction facilitation. SUWASA further assisted the WSPs to reach out to and apply for Aid on Delivery (AOD) funding from the German Development Bank (KfW), and Output-Based Aid (OBA) from the World Bank, through the Water Sector Trust Fund. In these schemes, a WSP obtains a loan from a commercial bank with an understanding that a portion of this loan will be paid off as a subsidy from either Aid on Delivery or Output Based Aid once the WSP has delivered agreed targets (See Figure 1). Once the deliverables are verified, the subsidy is paid by Water Sector Trust Fund directly to the commercial bank. It should be noted that for OBA, at the point when subsidy is agreed and signed, the Water Sector Trust Fund releases 10% of the funding to either the commercial bank, as the first repayment on the loan, if the commercial bank has already disbursed the loan to the WSP; or directly to the WSP as mobilization funds.
The role of partnerships
SUWASA’s success was due in large part to the fact that it worked in a favorable enabling environment conducive to cooperation. For its part, the Ministry of Water and Irrigation embraced and supported the idea of commercial financing as a tool for the sector; county governments provided letters of no objection, which were required by the banks; WASREB provided strong regulatory oversight that banks look to when underwriting a utility loan; the World Bank and KFW provided the financing for Output Based Aid and Aid On Delivery; Water Sector Trust Fund facilitated access to the Output Based Aid and Aid On Delivery; and USAID, through the Development Credit Authority, provided the guarantees that made it easier for the commercial banks to lend to a nascent sector. In effect, the success of SUWASA was the success of a multilayered partnership involving actors with different roles but willing to pull in the same direction.

Results and achievements
As indicated earlier, SUWASA supported eight WSPs in developing financially viable and technically feasible proposals and applying for commercial loans from three SUWASA-supported local banks. Six of the eight WSPs were successful, borrowing a total of KES 286 million (USD 3.2 million) with an average loan size of KES 47.66 million (USD 534,125). USAID Development Credit Authority partial credit guarantees were utilized in each instance and all loans benefited from either an Output Based Aid or Aid on Delivery subsidy, which ensured inclusive investments.

The projects provided over 8,000 connections benefitting nearly 20,000 people. None of the WSPs defaulted on their loans. Three loans have been repaid and three are on schedule to be repaid. Four of the six WSPs have gone back to the market since, all of them requiring either a Development Credit Authority or Output Based Aid/Aid on Delivery subsidy. Two of the three banks have also provided other loans to WSPs.

SUWASA had longer-lasting impacts besides successfully leveraging commercial financing to the sector. First, the idea of commercial financing has taken root, as evidenced by WSPs that did not originally participate having since proceeded to borrow from the commercial markets. Most significantly, over 11 WSPs are targeted to receive support for commercial financing under WASH-FIN, whilst a number are also in discussions to borrow from the capital markets through issuance of a bond through the Kenya Pooled Water Fund Facility (KPWF).

Second, SUWASA contributed significantly to laying a strong foundation for the sector to continue pursuing commercial financing by strengthening the interactions of both WSPs and commercial banks.
Key challenges
Despite the success, the process faced several delays related to three main factors. First, WSPs are required to obtain letters of no objection from their county governments to procure a loan. Depending on the understanding of the counties and the timing for engaging them, some WSPs were delayed or prevented from borrowing as there was resistance to providing these letters of no objection. This highlights the challenge associated with the ownership of the WSPs as public entities. Delays were also occasioned by limited coordination with other municipal service such as roads authorities who must be consulted for road cuttings. Limited capacity within the WSPs contributed to the lead time from commencement of discussions to actual transaction being rather long.

The second challenge was related to resettlement costs. Installation of services, especially in informal settlements, generally involves resettling affected communities. In conventional donor-funded projects, funds for resettlement are provided by the government. In the case of these commercial transactions, the funds were to be provided by the WSPs, an item which was not budgeted for and thus contributed to delays (and what the WSPs saw as unplanned costs).

The third challenge was the WSPs’ limited understanding of the nuances around Output Based Aid and Aid on Delivery processes (each has specific rules), which led to loss of time and frustration as some WSPs spent time applying for both and ending up not getting either, or applying for one and then after failing one, trying the other. This calls for stronger dissemination of requirements and coordination among development partners.

Issues to consider in going forward with commercial financing
As indicated earlier, advances made under SUWASA were acknowledged and have been spurred forward through efforts including the USAID’s Water Sanitation and Hygiene Finance (WASHFIN) and Kenya Integrated WASH (KIWASH) Projects, and the Kenya Pooled Water Fund (KPWF). As these current efforts begin to consolidate, it is worth highlighting some key lessons from SUWASA to ensure success. This is essential as meeting Kenya’s universal access goals will require all resources to be brought to bear, including commercial financing.

Creditworthiness involves more than good financial performance
Good governance and management integrity was highly valued by the commercial banks, and they considered it one of the most important criteria when lending to WSPs. This was the case with one WSP which despite a significant drop in WASREB’s Impact Report ranking, secured a loan for KES 81.3 million (USD 1.24 million). The bank noted management and governance as key factors to approving the loan. WSPs striving to access commercial financing must focus equal attention on good governance, involving both good internal systems as well as good relationships with the board and the county.

Open communication is crucial and can make or break the process
Under SUWASA, WSPs that engaged early with their boards and the county benefitted from political buy-in and alignment of critical-path procedures and approvals. Similarly, WSPs also benefited from proactive communications with the community, customers, and banks. Conversely, in one instance, lack of communications hampered implementation of a regulator approved and sanctioned tariff increase that was required for commercial viability. Early and regular communications with internal and external stakeholders is therefore critical to help manage expectations, and keep the process moving forward.

Commercial success requires community engagement
SUWASA demonstrated that weak community engagement can undermine the vision of socially responsible commercialization. For example, in Kisumu, the community did not fully understand the payment scheme for water connections, which impacted their willingness to pay. Without these connections, the project would not generate sufficient revenue for debt service. The ability and willingness to pay by the households established the extent of commercial viability, and where subsidies would be required. This in turn informed the design of payment schemes for connections and the need for operational resources. Incorporating community engagement in the final project structuring is therefore critical in creating less risky projects.
Credit enhancements improve the credit risk profile of a lending opportunity

SUWASA relied on credit enhancements to support WSPs in structuring transactions that appealed to banks. USAID Development Credit Authority partial credit guarantees were utilized for all six loans and each was further enhanced by an Output Based Aid or Aid on Delivery subsidy. Bundling these enhancements into a blended finance structure allowed WSPs to leverage their good governance and performance, in partnership with donors, to make needed investments on an inclusive basis that were repaid from future tariff revenue. The enhancements further introduced banks to a new sector, thus contributing to financial sector deepening.

The need for technical assistance and support remains

Even when an optimal level of governance and performance is achieved, WSPs will not necessarily have the internal capabilities or capacity to prepare bankable projects for financing. WSPs must therefore be self-aware of their strengths and weaknesses in accessing market finance. Technical assistance from donor programs such as WASH-FIN can help, especially at this early stage when the idea of commercial financing is being entrenched in the sector. However, a key question remains on how development partner programs like WASH-FIN can strengthen sector institutions such as the Water Sector Trust Fund, the regulator WASREB and associations such as the Water Service Providers Association, to effectively facilitate this support. In the long term, the goal must be to have this capacity institutionalized within WSPs, including the option of WSPs procuring these services from local consulting firms.

Technical assistance and outreach is needed for banks and institutional investors

Closing financial transactions requires not only the borrower, but also the lenders. SUWASA experience showed that banks and institutional investors remain unfamiliar with the WASH sector at best, and at worst, discount the sector as a viable part of their portfolio. Like any nascent sector, experience and time are required for banks to understand the risks and opportunities. Technical assistance and “market making” outreach to inform the sources of finance will remain a critical part of development partner support.

Conclusion

It is evident that with a favorable enabling environment and a spirit of collaboration, there is space for commercial financing in the WASH sector in Kenya. Indeed, despite it being a relatively new approach and facing some challenges, SUWASA catalyzed KES 286 million (USD 3.2 million) in private capital benefitting over 20,000 Kenyans with improved access to WASH services.

As WASH-FIN, KIWASH and KPWF programs commenced in 2016, the reform process advanced again with the enactment of the 2016 Water Act. This law aligns the “regulation, management and development of water resources and water and sewerage services” with the 2010 constitution. The Act maintains many institutions including WASREB, changes some such as Water Sector Trust Fund, and creates new institutions including Water Works Development Agencies for investment in national infrastructure. Sector institutions are still absorbing the implications of the new Act, in particular, the rights and obligations conferred on the new owners of the WSPs i.e. the county governments. How can these owners be brought on board to support commercial financing and what kind of technical assistance will be required to facilitate their engagement? These questions focus on governance, which as earlier noted, is critical to success of commercial financing and cannot therefore be overemphasized.

A related and critical issue that must be considered is the interest rate cap policy. As WASH service providers are generally perceived as more risky borrowers, an interest rate cap, may make it more difficult for the banks to extend credit at favorable terms. This policy may therefore hamper increased lending to the sector and must be considered.

That SUWASA was successful is also shown by the rollout of other programs on commercial financing in the country. Key among these are USAID’s WASH-FIN, which is intended to grow the activities undertaken under SUWASA both in terms of number of WSPs reached as well as commercial/private funds leveraged; KPWF, which is looking to issue a bond for WASH companies; and the World Bank-funded Performance-Based Financing, intended to leverage commercial financing for efficiency improvements. All these programs are targeting the same WSPs. The extent to which commercial financing and indeed each of these programs will succeed, is a function of government coordination and development partner collaboration.

Finally, the promise of commercial finance must be tempered with the reality that, as in other countries, public funds are required to deliver equitable services and surmount the challenges of an ongoing devolution
process. This was demonstrated during SUWASA, and even today, by the fact that to be commercially viable, each loan required multiple credit enhancements and considerable technical assistance.

In Kenya as elsewhere, Water Service Providers have generally inherited old and dilapidated infrastructure which requires significant investment to upgrade. Rapid economic growth concentrated in urban areas, and drought and other extreme weather events compound the need for these investments. At the same time, the low level of creditworthiness of WSPs means that there is limited capacity to take on commercial debt. It is sobering to consider that per the 2016 WASREB Impact Report, the total cost to achieve 100% water supply in Kenya by 2030 is estimated at KES 1.7 trillion (USD 17 billion), while the available government budget is KES 592.4 billion (USD 5.9 billion), leaving a shortfall of KES 1.2 trillion (USD 12 billion). Meanwhile, SUWASA only helped to raise KES 286 million (USD 3.2 million) whilst WASH-FIN is targeting USD 20 million over three years. Commercial financing can therefore only play a small, but important, part in closing the financing gap. However, the improvements in governance, and the discipline required for consumer-focused utilities to borrow and perform as commercial entities, brings a payoff that is difficult to quantify. Programs like WASH-FIN must therefore pay attention to blending and leveraging public with private funds. Commercial financing is only but a component of the total funding envelope, one that “frees up” scarce public funds to be used strategically to support inclusive investments.

Arguably, where SUWASA succeeded most was in deepening the concept of commercial financing and breaking down the barriers between the WSPs and the commercial banks. A key success factor for the current programs will be the extent to which new programs like WASHFIN can help bring WSPs to the point where less, or even no credit enhancements are required in the future.

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References

Notes
1. SUWASA was implemented in NINE countries: Kenya, Senegal, South Sudan, Mozambique, Zambia, Nigeria, Uganda, Ethiopia and Liberia, although commercial financing was only pursued in Kenya.
2. WASHFIN-Africa is being implemented in Kenya, Senegal, South Africa, Mozambique and Nigeria and will run from 2016 to 2021. WASHFIN is also in Nepal, Cambodia, Philippines and India.
3. As of December 2017. Data is still being compiled from SUWASA-supported WSPs.

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