Expanding Finance for Water Service Providers in Kenya

USAID's Water, Sanitation and Hygiene Finance (WASH-FIN) Program
Country Brief Series

INTRODUCTION. USAID's Water, Sanitation and Hygiene Finance (WASH-FIN) Kenya program, which started in April 2017, is working to support closing the financing gap between the currently available government budget and the total investment needed to reach universal water and sanitation access by 2030. The program operates in urban areas with creditworthy and/or efficiently managed Water Service Providers (WSPs) that have responsibility for both water supply and sanitation. By partnering with national and county governments, development partners, local financial institutions, and other stakeholders, the program supports public and private water and sanitation service providers in accessing additional capital for sustainable, climate-resilient water and sanitation infrastructure. By exploring new sources of finance, the program complements and leverages funding from traditional sources such as taxes, transfers, and tariffs, and supports the WASH sector in Kenya on its journey to self-reliance.

Key Takeaways

- Overcoming Fundamental Governance Challenges Can Unlock Commercial Financing;
- Government Leadership and Development Partner Coordination is Crucial to Maximize Sector Investment;
- Commercial Financing is Hampered by Lack of Bankable Projects, Weak Creditworthiness, and Limited Supply of Affordable Financing;
- Project Preparation and Transaction Support Can Build Stronger Demand and Link Access to Financing; and
- Commercial Financing Will Play a Small but Important Role in Sector Financing.

CONTEXT. Kenya signed its new constitution in August 2010 establishing a system of decentralized government comprising an elected national government and 47 elected county governments. Under this constitution, provision of water and sanitation was devolved to the county governments who took on ownership of corporatized WSPs created after the 2002 Water Act. The WSPs are autonomous entities established under the Companies Act and are responsible for both water and sanitation in both urban and rural locations. Their focus has been mostly on urban areas with potential for economic viability. Devolution of water and sanitation was further strengthened through the Water Act of 2016, which among others, allows the county-owned WSPs to seek investment finance from non-traditional sources[1], including commercial banks.

This interest in private sources of financing is driven by the fact that Kenya has set itself the goal to attain universal access for safely managed WASH services by 2030 but has limited public funding to do so. Presently, only 63 percent of the population have access to water and 31 percent have access to sanitation.[2] The estimated annual cost for Kenya to achieve universal access for water and sanitation is Ksh 100 billion ($930 million).[3] Yet only about Ksh 40 billion ($370 million) annually was available as of 2018, leaving a total shortfall for achieving Kenya's 2030 goal of Ksh 600 billion ($5.6 billion).[4] Filling this gap will require significant new forms of investment from public and private sources, hence the government of Kenya's interest in bringing in private sector financing.

Since 2012, the Kenyan government has been partnering with development partners to get commercial financing into the water sector. This included USAID's Sustainable Urban Water and Sanitation in Africa (SUWASA) program, which built on and worked in collaboration with the World Bank to assist WSPs in identifying viable projects and preparing for commercial bank loans under the Output Based Aid (OBA) program. This intervention helped commercial banks improve their understanding and ability to serve WSPs, resulting in loans to WSPs totaling Ksh 286 million ($3.2 million) by 2015.[5] Though loan amounts were small, the SUWASA program's results spurred further interest in commercial financing. The OBA program has continued, and new programs provided follow-on support to assist WSPs in accessing finance from local commercial banks and domestic capital markets were developed further. They include the German funded Aid on Delivery (AoD) program, USAID's Kenya Integrated Water, Sanitation and Hygiene (KIWASH), and WASH-FIN programs, and the Kenya Pooled Water Fund (KPWF) supported by the Dutch, USAID, DFID and SIDA.

USAID's WASH-FIN program was therefore designed to build on and complement these efforts as a way of contributing to closing the financing gap in the water sector.

DEVELOPMENT CHALLENGE. In working to develop, rehabilitate, and manage the infrastructure required to deliver WASH services, county governments and WSPs must mobilize resources from both public and private sources. While systems for mobilizing public resources are enshrined within relevant Kenyan legislation and are therefore relatively straightforward, mobilizing resources from private sources poses two fundamental challenges: (1) technical preparedness to engage with potential financing institutions, and (2) ensuring sector governance supports WSP engagement with private financing institutions.

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1 Traditional sources include transfers, taxes, and tariffs.
2 Kenya Institute for Public Policy Research and Analysis (2018-2019). Water and Sanitation Budget Brief, KIPPRA Policy Brief No. 66.
3 Ministry of Environment Water and Natural Resources, Republic of Kenya (2013). National Water Master Plan 2030, Final Report.
4 Kenya Water Services Regulatory Board (2019). Impact: a performance report of Kenya's water services sector – 2017/18.
5 See Kazimbaya-Senkwe 2018 for further discussion on SUWASA.

Pursuing and managing private financial resources requires strengthening capacity within county authorities and WSPs across a range of areas. For the WSPs to conclude any financial transaction with a commercial lender, they must have the ability to take on and repay loans by being creditworthy as well as having sufficient debt capacity (*i.e.* the fiscal space to acquire a loan). WSPs also need to have projects that have been fully designed and packaged in a manner that makes it easier for the potential lender to assess both their technical and financial viability. These conditions are generally not in place for most WSPs or infrastructure project designs in Kenya.

Apart from the technical and financial considerations noted above, most WSPs suffer from inadequate corporate governance, which in large part is subject to and a result of broader sector governance challenges. Decentralization requires an adjustment of roles and responsibilities. This adjustment takes time and as with any process of change, conflicts in relationships among water sector stakeholders invariably arise, with associated impact on both day-to-day WSP operations and the ability to attract commercial finance. A major issue, for instance, is that county governments as the new and sole owners of the WSPs do not yet fully appreciate their responsibilities as owners and the corporate governance behaviors required to properly manage the WSPs. This lack of appreciation leads to undue interference in the structuring and operations of the WSPs, including in raising finances. Secondly, some county governments are not sure about the role of private financing in the water sector and therefore refuse to support the WSPs in their quest for such financing. Any attempts to assist the WSPs to access commercial financing must therefore pay attention to these issues and other governance challenges in the sector.

The WASH-FIN program is designed to assist the Kenyan government to address both the WSP capacity gaps, as well as governance challenges. The activity's objective is to create financing options that expand access to or improve the quality of water and sanitation services in urban areas.

Objectives are achieved through technical assistance and capacity building for public and private water service providers, county and national governments, commercial banks, and other private finance sources in four areas: (1) tracking and documenting sectoral financial flows;[6] (2) investment planning with WSPs; (3) closing financial transactions between WSPs and private financiers; and (4) enhancing governance of WSPs and the sector more broadly.

I. Planning Financially Sustainable Investments

1.1 Helping Water and Sanitation Service Providers Strengthen Their Investment Planning

With the support of the autonomous Water Services Regulatory Board (WASREB), two WSPs were supported to produce business plans aimed at meeting criteria required to establish organizational creditworthiness and access commercial financing. WASREB requires the WSP business plan for regulatory compliance and further encourages its use as a tool to instill business practices geared toward helping utilities become financially viable and creditworthy.

This activity started with support to WASREB in updating their business planning guideline and training WSPs to use the guideline to produce short-term plans incorporating growth projections and other relevant changes in the operating environment. The plans include "hard" investments in new infrastructure, refurbishing existing schemes, as well as "soft" investments in staff capacity and improving

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[6] This brief focuses on financial transactions activities and also details TrackFin activity, which is still advancing under a government and development partner review process.

internal systems for cost effective service delivery. Production of the updated business planning guideline has contributed to WASREB's ability to more uniformly support and monitor WSPs. The guideline[7] was published in early 2019 and used successfully by two WSPs to prepare their first ever business plans.

At the WSP level, the WASH-FIN program began its support by undertaking creditworthiness assessments (see Box 1) for those WSPs wishing to pursue commercial borrowing.

Box 1: Creditworthiness Assessment and Debt Capacity Assessment

Creditworthiness assessments are a way of measuring the ability of an entity/person to qualify for and repay a loan. The assessment considers (1) financial management, including current debt obligations and historical debt servicing; (2) tariffs and ability to generate increasing cash flows; (3) governance and operational performance; and (4) regulation and its impact on growth and profitability of the entity.

Debt capacity assessments are a way of assessing the amount of financing (usually a loan) that a creditworthy entity can borrow without jeopardizing its overall financial position. The assessment is based on a financial model developed from the financial operations and project data to assess revenue streams from the proposed project.

Creditworthiness examines the overall status of the financial health and capacity of the borrower while debt capacity looks specifically at the amount of debt that the borrower would be able to repay.

During this time, there were several WSPs engaged in conversations on potential borrowing, including through the KPWF.[8] To aid this process, the program also began facilitating debt capacity assessments (see Box 1) to account for the impact of existing legacy debts, which are largely sovereign loans procured through the regional Water Boards (now called the Water Works Development Agencies) with the expectation that the WSPs would pay the loans through their sale of water and sanitation services. However, the process of transferring these loans (and other liabilities and assets) remains unclear and contested as the devolution process continues, resulting in an ongoing lack of clarity on who has accountability for this debt. Nonetheless, the fiscal discipline required by private lenders meant that the WSPs had to factor these loans into their financial models, hence the need for the debt capacity assessments.

Of the 88 WSPs, the program has so far completed creditworthiness assessments for 25, from which nine were deemed creditworthy, at the time of those assessments. Of these, four were supported to prepare technical and financial proposals for commercial financing, which resulted in commercial loans for two WSPs, while the other two are at different stages of finalization.

The program also successfully completed debt capacity assessments for five of the nine creditworthy WSPs, which were looking to borrow from the KPWF, to determine how much debt they could take on. This resulted in these WSPs reconsidering their realistic debt capacity and which loans to pursue. In one case, the WSP found that it could only afford half of the original Ksh 400 million ($3.7 million) loan it was discussing with KPWF. The WASH-FIN program also provided a legacy debt restructuring proposal for one of these WSPs, which is being used as a basis for discussion with the National

7 WASREB Business Planning Guidelines: https://wasreb.go.ke/business-planning-guidelines/
8 The KPWF is designed to make the water sector attractive to capital markets by pooling several WSPs that can borrow through issuance of a bond. See https://kpwf.co.ke/

Treasury. If restructured, this would increase the WSP's capacity to pursue the KPWF or other repayable financing options.

Apart from the creditworthiness and debt capacity assessments, it was also necessary to assist the WSPs in developing complete engineering designs, and on prioritizing projects with the most beneficial technical and financial outcomes. Therefore, WSPs were supported to define and properly package their technical proposals to be more "bank facing," showing clear linkages between technical and financial viability.

To complete the transactions, the program supports the WSPs that are willing to borrow, to develop, and execute fundraising strategies involving commercial banks and the KPWF. The facilitation activities include supporting financial modeling and proposing various investment structures, assisting with preparation for negotiations, and troubleshooting any matters that may be preventing transaction closure.

Apart from the public WSPs, the program has also been supporting two private sanitation service providers (Sanivation and Sanergy) that are rolling out novel sanitation technology solutions for low-income areas, to raise financing for scaling up their activities. Sanivation, which is based in Naivasha town, provides portable toilets to households and recycles fecal matter into pellets for energy. Sanergy, based in Nairobi city, also provides portable toilets and recycles fecal matter into organic fertilizer. Sanivation has received support in market segmentation, financial modelling, and preparation of investor outreach materials. The work with Sanergy involves defining a financing mechanism that will facilitate greater engagement of the public sector, potentially through some form of results-based financing. The support to these companies is contributing to both the goal of universal access to sanitation and environmental protection.

1.2 Engaging Domestic Commercial Financing Institutions to Increase Investments in the WASH Sector

The WASH-FIN program regularly shares information with commercial banks that have shown interest in the WASH sector, specifically: creditworthiness in the WASH sector, market opportunities for lending and investing, and how to tap into these opportunities. This is undertaken through provision of information and engagement with each individual bank as well as facilitation of group knowledge sharing sessions for all interested banks. One key success was a knowledge sharing event, which was co-facilitated with WASREB in February 2020 and attended by 11 banks, namely Barclays Bank (now ABSA Bank), Cooperative Bank of Kenya (Coop Bank), Kenya Commercial Bank (KCB), NCBA Bank, Sidian Bank, Bank of Baroda, Citibank, Ecobank, ABC Bank, Equity Bank, and Faulu Bank. Although Family Bank, Coop Bank, and Sidian Bank are the ones that have been fully engaged in providing loans to the WSPs, the attendance by all the other banks and follow-on meetings with two banks after the event, showed that there is interest in the sector and that the knowledge sharing events are seen as useful.

To date, the program support has resulted in $4.2 million raised ($1.75 million for two WSPs from commercial banks and $2.3 million for a private sanitation enterprise from a combination of commercial loans and grants). Sanivation is using this finance to expand its business of providing access to toilets for households in low income areas and production of briquettes that are replacing charcoal as an energy source in Naivasha town in Kenya. This contributes to conserving Kenya's forests and financially empowers households involved in the sale of briquettes business. The loans acquired by the two WSPs are not purely commercial but are both backed by the OBA subsidy and in one case partially guaranteed by USAID. As a result of these two loans, 688 households gained new water connections and 2600 households gained new sewer connections (see Box 2).

Box 2: Improving Water Supply and Sanitation through Output Based Aid Loans in Karatina and Nyeri Towns

Through collaboration with the Water Sector Trust Fund (WTSF), the implementing agency of the World Bank-backed OBA program, the WASH-FIN program assisted Mathira Water and Sewerage Company (MAWASCO) to access finance to rehabilitate and expand urban water supply in Karatina town. MAWASCO raised Ksh 108 million ($1.08 million) in commercial financing, which has seen water network rehabilitation of 45.3 km across the town. With the increased water supply, MAWASCO has provided 688 new household connections resulting in approximately 3,440 more residents getting access to clean drinking water. Some residents have also seen an 87 percent reduction in monthly water purchase costs from private vendors, with the savings used to cater to other household needs. Additionally, significant time savings has been achieved, as previously many would source water from shallow dug wells or boreholes with long queues consuming most of their morning.

Through the same collaboration, the WASH-FIN program also assisted Nyeri Water and Sanitation Company (NYEWASCO) to undertake a debt capacity assessment, which enabled the company to increase an existing OBA loan by $800,000. The financing enabled NYEWASCO to provide new sewer connections to about 2600 households, resulting in over 22000 people benefiting from improved sanitation. Although the project was only recently completed, it is expected that it will lead to improved living environments and less groundwater pollution. Households that previously had to finance emptying of pit latrines and septic tanks, will also no longer have to face the associated financial burden. For NYEWASCO, the project also means an enhanced revenue stream from sewer services. The program engagement also involved working with the commercial bank to minimize their demands for guarantees from the WSP, and rather to take full account of the DCA provided by USAID. Other support included customer mobilization, which resulted in achieving the required target numbers for the WSP to qualify for the OBA subsidy.

It is important to note that a potential pipeline of $11.5 million was prepared for five WSPs but they have not been able to close these financial transactions due to governance challenges that are discussed below.

2. Enhancing Governance

As the WASH-FIN program became increasingly engaged with WSPs, the depth of the governance challenges, which had been identified at the start of the program[9], and the need to pay greater attention to them was brought to the fore. In addition to the issues highlighted in the development challenge section above, the governance challenges manifest in several ways, as discussed below.

The first and most significant challenge is the high level of mistrust, sector dysfunction, and a lack of adherence to an intergovernmental collaboration framework that was signed after a very long delay, in 2018. This is due to the incomplete and highly contested transfer of functions and resources from the national to the county governments. Many county governments feel they have been short-changed by the national government and consequently make operations of the WSPs rather difficult, especially if these involve interaction with the national government. This has been partially the case with the KPWF, which is seen as a national government initiative. For their part, the WSPs have their own internal

[9] SUWASA Look Back Study.

governance challenges, including weak systems for monitoring and managing non-revenue water and inadequate management of customer debts, which makes them inefficient and creates mistrust by the county governments. Finally, the sector does not have a coordinated financing strategy but rather exhibits a disjointed system replete with duplicated and competitive development partner efforts targeting the same WSPs. All these factors have created confusion among the WSPs and make private financiers unsure about lending to the WSPs.

These challenges compelled the WASH-FIN program to intensify its focus more deeply on the governance of the WSPs and the sector more broadly. Key activities undertaken have included facilitating dialogue with key stakeholders at both national and county level on WASH sector governance and undertaking critical analyses to inform public debate on the same. In 2019 for instance, the program supported the Council of Governors (COG) to convene the first ever water and sanitation sessions at the Fifth National Devolution Conference. This inclusion of WASH in the broader devolution agenda placed governance of the water sector prominently on the political agenda, culminating in a commitment by the COG to begin to address the governance challenges in the water sector, including pushing for greater funding to the sector at both national and county levels.

Key analyses include detailed assessment of drivers of low creditworthiness in WSPs, an ongoing assessment of the political economy of the WASH sector, which is examining how the evolving relationships between the national and county governments are impacting the operations of the sector, and a review of the challenges encountered by the KPWF. This enhanced focus is consistent with core aspects of institutional system strengthening, resource optimization, and sustainability.

The program also engages at the WSP level in order to help remove governance challenges that may be preventing financial transactions. As an example, in 2018, the program successfully assisted one WSP to get buy-in from the county government, allowing it to take on a commercial loan, which the county government had previously been unsure about. Two WSPs have also been assisted in developing and rolling out customer outreach programs, which has resulted in one of them connecting over 1400 customers to their network, enabling the WSP to obtain a subsidy from the World Bank under the OBA program.

LESSONS LEARNED

1. Overcoming Fundamental Governance Challenges Can Unlock Commercial Financing

The WASH-FIN program realized early in its implementation that an imbalance between devolution of mandates and devolution of capacity does not deliver results. For devolved county governments, uncertainty in governance rules, responsibilities, and resources impacts the ability of WSPs to borrow. Under the program activity, for example, aside from the $1.75 million that has so far been raised for two WSPs, five other potentially viable commercial loan transactions totaling $11.5 million, that were under discussion, have not been able to close because either their shareholders (*i.e.* county governments) summarily changed the boards of directors or the management teams, without considering their capacity, changed the organizational structure of WSPs, or were not convinced about the potential sources of financing being pursued by the WSPs. In two cases, the WSPs either had a significant legacy debt or had other internal governance challenges. All these challenges and uncertainties equate to an unacceptable level of risk that results in private sources of capital shying away from WASH investments and deploying their capital elsewhere. As the transition to county control continues, nurturing strong internal governance as well as cordial relationships between WSPs and county governments is critical to achieving financial access goals.

2. Government Leadership and Development Partner Coordination is Crucial to Align Incentives and Sequence Interventions to Maximize Sector Investment

In addressing the governance challenge, it is also important to re-examine the leadership role of the national government and its development partners. One of the reasons the WASH-FIN program supports WSPs to undertake debt capacity assessments is because the strongest WSPs are targeted by almost every development partner program for both concessional and commercial loans. This not only makes it difficult for the WSPs to decide which financing to pursue, but also prevents public financing from getting to other weaker WSPs. Since the sector often has a lack of well-designed projects ready to be financed, the WASH-FIN program has seen instances in which development finance institutions simultaneously undercut local commercial banks, while competing among themselves to finance the few creditworthy providers with properly designed projects. Meanwhile, the disbursement of grant funding for capital investment, independent of blending other sources, may also displace financing opportunities for service providers lower down the credit ladder. To close the financing gap and achieve universal coverage, a disciplined "all of the above" approach that balances the benefits, risks, and alternatives is required. Making sure that scarce public funding and development partner resources are being used in an increasingly strategic manner, can assist the government in leveraging repayable financing options to expand coverage. Using performance-based metrics, close cooperation, sequencing of programs, and a focus on mobilizing local private capital can contribute to a rationalization of incentives to leverage more resources.

This type of approach however requires government leadership to ensure that grant and concessionary financing are well targeted to utilities that are moving up the creditworthiness ladder. Effective government leadership and development partner coordination is required to drive efforts away from misaligned incentives that crowd-out financing. The goal should be to move the sector towards properly aligned incentives and sequenced interventions that crowd-in all available sources of public funding and when possible, commercial market financing.

3. Commercial Financing is Hampered by Lack of Bankable Projects, Weak Creditworthiness, and Limited Supply of Affordable Financing

In assessing the creditworthiness of the WSPs, the program found low operations and maintenance cost coverage, high Non-Revenue Water (NRW) losses, and excessive unpaid bills from customers with high debtor days as key drivers of low creditworthiness. These are all indicators of internal technical and administrative inefficiencies and represent an existential threat to WSP operations and ability to access credit.

From the business planning exercise, it became clear that most WSPs did not have requisite capacity to effectively communicate their financial viability and plans to internal and external stakeholders. It is anticipated that the tools being developed under the WASH-FIN program, including the (1) creditworthiness assessments; (2) debt capacity assessments; (3) comprehensive business plans; and (4) the business planning guideline will serve as important guides, especially if they can be institutionalized by WASREB in the regulatory and licensing processes for WSPs.

The cost of borrowing from commercial lenders (over 12 percent annually in Kenya) is too high for the WSPs, given that water, though an economic good, is also a public health good. Water service providers are therefore looking for financing that is cheaper than commercial loans, irrespective of their level of creditworthiness. This challenge is further compounded by other requirements such as collateral and guarantees, which make commercial financing unattractive. The limited experience of private financiers and the lack of specific loan products for the water sector, makes lenders unsure of the sector and therefore very risk averse.

4. Project Preparation and Transaction Support Can Build Stronger Demand and Link Access to Financing

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 helped to be self-aware of their strengths and weaknesses in accessing market finance. Technical assistance from development partner programs can help, especially at this stage, when the idea of commercial financing is still being entrenched in the sector.

The WASH-FIN program experience has reaffirmed that banks and institutional investors remain unfamiliar with the WASH sector at best, and at worst, discount the sector as not 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 and help in designing specific WASH finance products will remain critical parts of development partner support. Such support must also deliberately strengthen local sector institutions to effectively facilitate this support in the interest of a self-reliant WASH sector in the long term.

5. Commercial Financing Will Play a Small but Important Role in Sector Financing

The promise of commercial finance must be tempered with the reality that in Kenya, as in other countries, public funds are required to deliver equitable services and surmount the challenges of an ongoing devolution process. The low level of creditworthiness of WSPs means 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 percent water supply by 2030 is estimated at Ksh 1.7 trillion ($17 billion), while the available government budget is Ksh 592.4 billion ($5.9 billion), leaving a shortfall of Ksh 1.2 trillion ($12 billion). Meanwhile, the WASH-FIN program has so far only helped to raise Ksh 286 million ($3.2 million) against an initial target of $20 million over three years. Not only are these loans small, but they also combined credit enhancements in which banks were at most taking on only 50 percent of the risk (with a credit guarantee) or 30 percent (in cases where there is 50 percent credit guarantee from USAID and 40 percent OBA), to as low as 20 percent (in cases where there is 50 percent credit guarantee from USAID and 60 percent OBA). Given the low creditworthiness of the WSPs, this is probably what is required for now and must be intensified and sustained by the government until the sector is able to stand on its own financially. To further illustrate this point, all the commercial bank loans ever issued for WASH in Kenya from inception of the OBA program and SUWASA, totaling approximately $12.7 million, amount to just 3.4 percent of the annual funding required to meet universal water and sanitation targets. For the moment, therefore, commercial financing can only play a small but important role in closing the financing gap.

The importance of this limited commercial financing is the unquantifiable payoff resulting from improvements in governance and financial discipline required for consumer-focused utilities to borrow and perform as commercial entities. Current and future programs or projects must therefore pay attention to blending and leveraging public funds with private investment, as commercial financing will be only a component of the total funding envelope, which "frees up" scarce public funds to be used strategically to support inclusive investments.

Arguably, the ultimate success of a program like WASH-FIN will be the extent to which it succeeds in entrenching the idea of commercial financing; breaking down the barriers between the WSPs and private lenders; and the extent to which it can help bring WSPs to the point where less, or even no credit enhancements are required in the future.

ABOUT THE WASH-FIN PROGRAM. USAID's WASH-FIN program works in collaboration with national governments, development partners, financial institutions, service providers, and local stakeholders in eight countries. The program's Country Briefs summarize the development challenges, activity design, and results to date for each country of operation. The briefs focus on the lessons learned and their applicability in each country, as well as for USAID, and the broader water and sanitation sector.