

Financing Water Service Improvement

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The challenge

Water service coverage in Central America lags behind the rest of Latin America, and may slip further behind as aging water infrastructure fails into disrepair. Lack of regular capital maintenance is part of a vicious cycle whereby *low service quality prevents water service providers (WSPs) from charging sufficient fees to sustainably maintain systems, leading to further degradation in service quality.* Regular investment in capital maintenance is required to avoid a “build and fail” syndrome that ultimately requires more capital to rehabilitate failed systems.

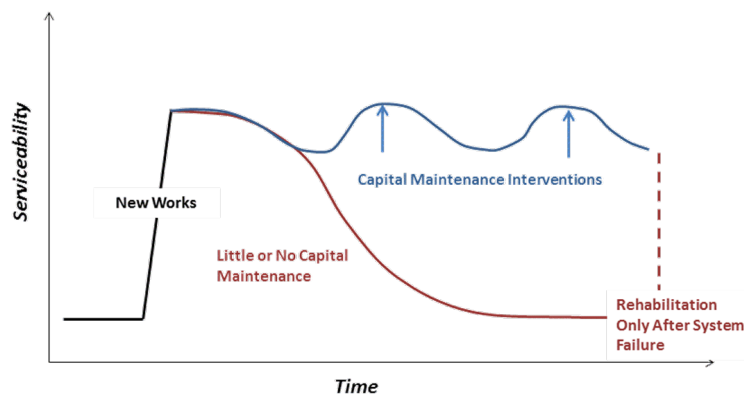


Figure 1: Regular capital maintenance versus emergency rehabilitation

More efficient allocation of public resources

International donors and national governments tend to spend the majority of their resources on water infrastructure. Lack of investment in the management and operational capacity of WSPs increases the frequency and severity of infrastructure failures, and ultimately limits return on investments in new water infrastructure. New infrastructure is important to provide safe drinking water to new users, but failing infrastructure due to the lack of effective capital maintenance jeopardises Latin America’s attainment of 2015 millennium challenge goals for water access.

Instead of investing almost exclusively in infrastructure, donor resources would achieve greater long-term impact if they focused on the capacity development of WSPs. Low-quality service providers should not receive infrastructure funding until management operations are improved. Further, donor resources should be used to catalyse private sector finance of water system improvements through loan guarantees, co-investments, and the promotion of creative finance mechanisms such as social improvement bonds and public private investment funds.

Rural water users can pay higher monthly fees

A critical question when considering finance provision to WSPs is whether water users, especially in rural areas, are willing and able to pay higher user fees for improved service delivery. A commonly held belief among development agencies and public officials is that rural water users are not able to pay sufficient fees for operational and capital maintenance cost recovery. In reality, however, the real cost of drinking water for rural households is often much higher than the cost of water in urban areas. Many rural households purchase bottled water and pay for tank services at up to four times the cost of household tap delivery in other areas. Further, where rural households have access to household water services (by rural water committees, municipalities, etc.), they have been willing to pay higher fees than their urban counterparts. A higher percentage of households paying above \$3 per month are located in rural areas. Evidence suggests that users are willing to pay more for better services (with 10 out of 13 WSPs with fees above \$5 per monthly being designated as “Class A” service providers). One area of concern, however, is that far more rural water systems fall into the lowest service quality classification (D-Class, in red below).

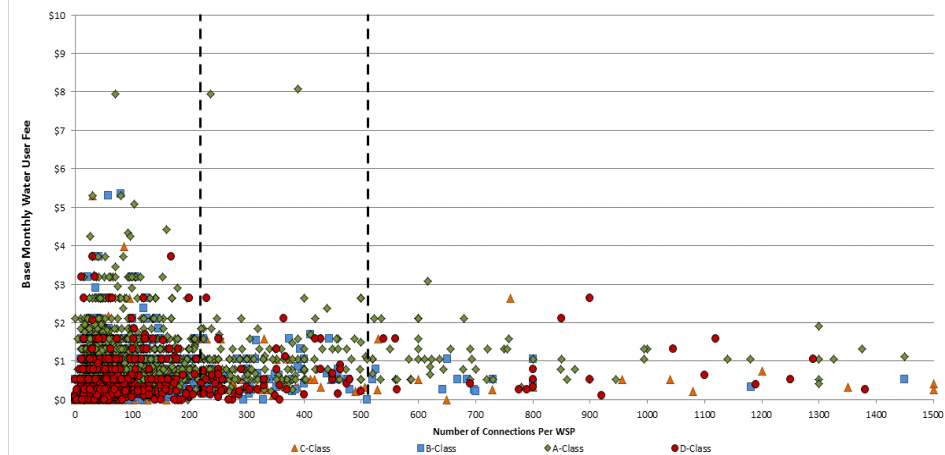


Figure 2: 2012 water user fees by service quality and number of connections - Honduras

Finance is feasible at *current* user fee levels

AO and CRS catalogued prevailing user fees in Honduras (5,000 water service providers) and El Salvador (85 water service providers). Although no mechanism for water fee data collection exists in Guatemala or Nicaragua, AO and CRS assessed the performance and resulting water fees for ten service providers.

AO created a base financial model to project feasible loan sizes for water service providers based upon interest rates, repayment periods, number of connections and user fees.

Financial models demonstrate that water service provider loans become feasible at \$1.06 per month for service providers with at least 300 connections. For smaller water service providers, loans become feasible at roughly \$2.50 per month – a fee level above which hundreds of Latin American service providers currently charge. As the number of connections increase, so does the feasible loan size (as total service provider income increases). For example, minimum feasible loan sizes for 700 connections at \$1.54 reach over \$35,000 for a 10-year, 10% APR loan.

Finance alone is not enough

Although a significant number of water service providers have the economic fundamentals to secure commercial finance for service delivery improvement, access to finance alone will not be sufficient to improve access to safe drinking water in Central America. Facilities incorporating coordinated technical assistance with creative finance mechanisms will be necessary to attract private capital and maximise the impact of water system investments. Technical institutes should be developed to provide technical assistance, conduct policy analyses, engage in policy advocacy, and to implement strategic communications campaigns that facilitate WASH-related behaviour change. Technical assistance should be delivered via vouchers to co-fund WSP engagement of private sector firms for engineering and design services, business plan development and financial management training. Cooperation between public agencies, donors/NGOs and academic institutions will create cost efficiencies and coherent, consistent technical assistance packages to prepare WSPs to deliver improved services and responsibly utilise finance and investment for system improvement.

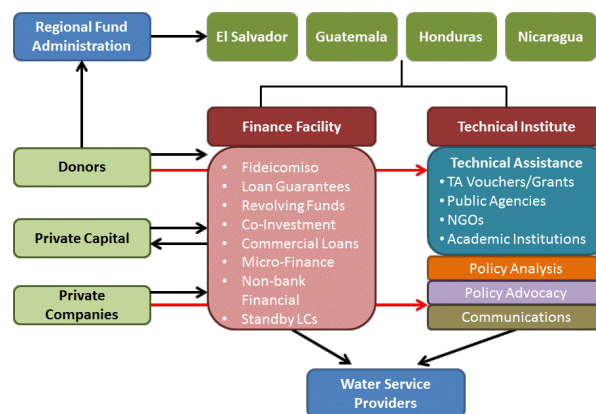


Figure 3: Recommended design of national capital facilities.

Strategies to catalyse private sector finance

Most commercial banks in Central America do not include water and sanitation among their core lending sectors. Many bankers are not familiar with the WASH sector, and therefore tend to over-estimate risks associated with credit provision to the sector. Higher risk profiles translate into higher interest rates, which bankers estimate would be 18 to 24% per year for WSP loans. Although some WSPs could qualify at these high rates, interest rates between 4% to 8% would allow for acceptable returns on capital while increasing feasible loan sizes and allowing a greater portion of WSP resources to be used for water source purchases and improvement of management systems.

Government agencies and international donors can work together to lower risk perceptions within the finance sector. First, promotion and outreach will increase familiarity with the sector and demonstrate the sector's viability for private investment. Second, public partners can mitigate risks through partial loan guarantee funds and co-investment, which yield lower blended interest rates. Third, piloting of finance initiatives can provide "proof of concept" evidence to the commercial banking sector. Lastly, public partners can engage private companies concerned with water stewardship (such as Coca-Cola) for training and co-investment in improved water services.