Financing Water for All

Report of the World Panel on Financing Global Water Infrastructure

EXECUTIVE SUMMARY

1. The Panel

A World Panel on Financing Global Water Infrastructure was formed late in 2001. This was a joint initiative of the Global Water Partnership, the World Water Council, and the 3rd World Water Forum in Kyoto, with the financial support of several donor agencies.

The Chairman of the panel is M.Michel Camdessus, formerly Managing Director of the International Monetary Fund and now Honorary Governor of the Banque de France. Its members are 20 personalities with top level experience in politics, finance ministries, international development and financial agencies, banking, Non-Governmental Organisations, and private water companies, plus eminent independent professionals.

The panel had 7 full meetings, in Manila, Washington, Johannesburg, The Hague, Paris (twice) and London. The Chairman and other panel members also went to other key water conferences and gatherings. It heard evidence from a wide range of people from different parts of the water and financial sectors across the world. Its report will be presented to the Third World Water Conference in Kyoto in March 2003.

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The subject matter of the panel is the financial needs of the water sector in its broadest sense, taking a 25-year perspective. This includes household services, irrigation, hydropower, resource development and management, flood control, etc., though the needs of domestic water supply and sanitation have taken up the largest part of its time. Its geographical focus has been developing and transitional countries.

During its deliberations the panel has become convinced that water is one of the most important issues in the world today, and that the achievement of water security would do more for poverty, development and the other Millennium Development Goals (MDGs) than almost any other conceivable actions.

2. Landmarks in the Growth of a Consensus

Over the last ten years there have been a number of crucial landmarks in the development of a broad international consensus on water, starting with the first Earth Summit in Rio de Janeiro in 1992. The Third World Water Forum in Kyoto in March 2003 will be the latest and most comprehensive gathering on the subject. There is now broad international agreement on what needs to be done.

The United Nations in its Millennium Development Goals ('MDGs") set a target for halving by 2015 the number of people without safe water. This aim was extended to household sanitation at the Johannesburg Earth Summit. In 2000 it is estimated that 1.1 bn. people lacked access to safe water supply and 2.4 bn to proper sanitation.

Allowing for the expected growth in population, reaching the UN targets would entail providing water to an additional 1.5 bn.. people and basic sanitation to an extra 2 bn.. by 2015 . In the thirteen years remaining before 2015, attaining the targets would mean *daily* global connection rates of several hundred thousand for both water and sanitation.

2015 is an important interim step on the way to full water security by 2025, which has broader financial implications. Current spending on new water infrastructure in developing and emerging countries is very roughly USD 80 billion *annually*. Over the next 20-25 years this will have to more than double, to around USD 180 billion. Much of the increase will be for household sanitation, wastewater treatment, treatment of industral effluents, irrigation and multipurpose schemes.

3. Global water: the current situation

There are glaring global inequalities in the supply of water infrastructure and services. One indication is water storage, where the USA and Australia have 100 times more storage per head than Ethiopia. Likewise for the development of hydropower: in Europe and North America 70% of potential has been developed, in Asia only 30%. In Africa, where 40% of the population has inadequate access to water and sanitation, only 3% of renewable water is withdrawn for human use, only 6% of its land is irrigated and only 5% of its hydropower potential is used.

There are also large global deficits to recover in the provision of water services. The percentageof population without access to water is around 40% in Africa, 20% in Asia and 15% in Latin America and the Caribbean. The corresponding deficits in sanitation are, respectively, 40%, 50% and 20%. The situation is not a static one: overall populations are going to increase, and the urban population alone is expected to double in Africa and Asia over the next 25 years.

Extension of water and sanitation services will increase the urgency of proper collection, treatment and disposal of wastewater, including industrial effluents, in all of which there are enormous investment backlogs to make up. In the area of Water for Food, over the next 30 years the area of irrigated land is likely to have to increase by 22% and water withdrawals by 14% to meet the needs of a larger world population.

To overcome these deficits, finance will need to be drawn from all sources. At present, water users barely pay for even the running costs of their services, with no contribution towards capital outlays. The situation is even worse in irrigated farming, which is heavily subsidised. Domestic governments cover most of the cost of new investment, with the balance coming from foreign aid, international loans, private investment and voluntary donations.

All governments have limited budgets and many have offloaded the task of financing water to local bodies. Most water authorities and utilities are unequal to this task, unless they reform themselves and increase their revenues through tariffs. Commercial loans and private investment in water have both declined in recent years, and their short- term prospects are uncertain. One of the few positive notes is the better outlook for foreign aid, following recent donor pledges.

4. The Roots of the Problem

There has been general agreement in the expert presentations made to the panel that the water sector's problems arise partly from weaknesses in governance, and partly from risks that are specific to the sector. These factors apply in varying degrees in different parts of the sector – urban water supply obviously differs from irrigation and hydropower, for example.

In the realm of *governance*, the main problems are:

- The apparent low priority given to water sector issues by central governments
- Confusion of social, environmental and commercial aims
- Political interference
- Poor management structure and imprecise objectives of water undertakings
- An inadequate general legal framework
- Lack of transparency in award of contracts
- Non-existent, or weak and inexperienced regulators
- Resistance to cost-recovering tariffs

The main *sector specific risks* are the following, which apply to all commercial financial sources , whether from the private or public sector

- Project profile: capital intensive with high initial investment and long payback period
- Low sector rate of return
- Foreign exchange risk: mismatch between revenues in local currency and finance in foreign currency
- Sub-sovereign risk: decentralised water agencies with service responsibility but lacking financial resources and credit standing
- Risk of political pressure on contracts and tariffs, with weak and inconsistent regulation
- Contractual risk: projects of long duration entered into on the basis of poor initial information.

Country ("sovereign") risk is also present as a general constraint on international finance, not limited to the water sector. Very few emerging markets have investment ratings that enable them to raise funds on attractive terms. Water projects have the additional disadvantage that there is a high minimum size of project finance, due to the size of legal costs, and the terms for water projects. International project finance has large returns to scale because of the legal, financial and due diligence costs associated with it. Many water projects may not be viable for project finance because they fall below the minimum size for this form of finance.

5. Proposals

The panel's *general conclusions*, which underlie its proposals, can be summarised as follows:

-there is widespread agreement that the flow of funds for water infrastructure has to roughly double, and the increase will have to come from all sources.
-governments have not in practice been giving enough priority or resources to their water sector. Because the sector tends to be decentralised, policies need to be addressed to the appropriate levels.
-sector institutions badly need reforming if they are effectively to absorb increased funding. A major effort of capacity building is required, with the support of donors and other parties.
-sustainable cost recovery is essential, both from the generation of more internal funds, and from governments creating a stable future framework for revenue transfer.
- responsibilities for water have been delegated to local bodies, a move in the right direction, but without conferring enough powers, human resources and finance to make it work
-local community organisations and local businesses are vital to the task of improving services and need better access to resources and powers to do this. Service-oriented NGOs can be a useful support.
-international loans and equity investment in water have been low and falling; banks and private companies are now more aware than ever of the risk-reward trade-off.
-official aid for the water sector has also been falling, but there are good prospects for a reversal of this, provided the sector is restructured to absorb it efficiently. Aid increases should be well targeted and used to stimulate flows from other sources.
-the sovereign risk on projects, including foreign exchange risk, is a key disincentive that must be addressed if international loans and equity are to be attracted to water projects in emerging markets

The panel's main *proposals* are the following, grouped by the main themes:

Central government actions
Each country should produce a national water policy and plan, including specific programmes to meet the MDGs and beyond, which would be part of an agreement for additional official development assistance (ODA) for water. Countries should report annually their achievements towards the water MDGs. Governments should provide predictable public revenue frameworks to their water service providers, and create the conditions for private funding, including regulation..

For the group of Highly Indebted Poor Countries water should be explicitly included in national Poverty Reduction Strategy Papers in order to give it higher priority in national budgets and capture some of the benefits of debt relief for this sector.
Donors should keep funds available for rewarding countries that make early progress on implementation of water programs in fulfillment of the MDGs.

Local governments and water authorities
Central governments need to work out better financial relationships with sub-sovereign bodies with crucial responsibilities for water, such as local governments and water utilities. Finance Ministries should give sub-sovereign bodies enough financial freedom to carry out their tasks. Municipalities should cooperate in credit pools to raise finance. Well-run national development banks could be considered as suitable channels for funding local bodies. Sub-sovereign bodies should be given credit ratings. More work should be done to simplify and standardise contracts and leases. Donors and MFIs[1] should target sub-sovereign bodies with their technical support, aid and loans, and remove unnecessary constraints to lending to them.

Promoting local capital markets
Both public and private water providers should be able to borrow more of their capital locally, thus reducing the foreign exchange risk. Governments and central banks should encourage the growth of local capital markets and attract more local savings (e.g. from pension, mutual funds and other institutional investors) into suitable local outlets.MFIs should make greater use of guarantees and other instruments to encourage more long term local lending, and raise more of their resources in local currency markets.

Sustainable cost recovery (SCR)
Water service providers should aim for revenues sufficient to cover their recurrent costs, and should develop sustainable long-term cost recovery policies, anticipating all future cash flow needs. SCR includes operating and financing costs as well as the cost of renewing existing infrastructure.

Revenues arising from charges should be covered by users as a group. Under SCR, not all users need pay the same price. Individual affordability of water charges should be ensured by appropriate tariff structures including local cross-subsidization (for example by setting a rising block tariff structure) and/or by individually targeted and transparent pro-poor policies. That part of recurrent revenues provided by taxpayers from public budgets should be secured by agreeing the allocation of sufficient fiscal transfers a long time in advance. Sufficient fiscal transfers should then be earmarked as appropriate to meet central support commitments. Subsidies should be transparent and reviewed continuously to ensure they target the intended beneficiaries.

Increasing managerial capacity
Funding for capacity development in water institutions should be a high priority for the use of ODA. Donors should finance trust funds in the MFIs for using foreign specialists in the transfer of experience, particularly at an operational level. They

[1] Multilateral Financial Institutions

should support cooperation between experienced and reputable partners, including those from the public sector, as a means of strengthening core public capacities.

<u>ODA technical cooperation should preferably be used as a means of enhancing 'on the job' capacity building for strengthening the public sector and in the preparation and implementation of projects and programmes., including those involving private sector participation (PSP). The panel commends the concept of 'learning while doing' and believes that donors should support "action planning", in which planning and project preparation are wrapped into aid projects</u>

Corruption & ethical practices
Corruption is an issue in both the public and private sectors. Executing agencies should be made attractive for high-calibre leadership, accountable for performance and delivery. Integrity standards should be worked out, agreed and implemented by all interested parties. The high political profile of water should be used positively to create more transparency for its operations. Public opinion, user associations and NGOs should be encouraged to monitor and publicise the activities of water organisations and expose corrupt practices. Companies and public contractors engaged in the water sector are urged to cooperate with other parties involved to develop methods for promoting ethical behaviour.

The legal & regulatory environment
The panel recommends the creation of a Revolving Fund consisting of grant money to finance the public costs of preparation and structuring of complex projects , including PSP and other innovative structures . The fund would be used to assist in the preparation and structuring of project bids (including legal, financial, and technical advisory costs) at both the tendering and negotiation phases. The Fund would be replenished by the authorities once bids were accepted . The panel also recommends funding a study for the preparation of best practice and model clauses in the legal agreements of public-private partnerships, with particular reference to the water sector.

Turning to specific *financial instruments and facilities,* the panel proposes the following.

Official _development assistance (ODA)
Donors should be held to account for their commitments to increase aid to the water sector. Overall ODA for water should be doubled, as a first step, and the share of water in total ODA should increase substantially from its current level. Individual donors should contribute their share towards this target, depending on the size of their current aid to the water sector. This ODA increase should preferably be done by increasing the amount of grants.

Donor agencies should work, under the guidance of the OECD's Development Assistance Committee (DAC), the UN and the Development Committee to implement DAC recommendations on increasing the effectiveness of aid. They should aim to coordinate their efforts in this sector, and avoid the waste and fragmentation typical of earlier water programmes.

In view of the capital-intensive nature of water investments, and the need for 'front loading' of ODA, means should be found for governments to create a special national or international facility to pre-finance disbursements budgeted for a later period.
The panel urges DAC to consider amending its presentations of national ODA performance to reflect properly the status of guarantees.Geographically, ODA should favour those countries, especially in Africa, where the water service deficit is greatest and where most remains to be done to meet the water MDG targets. Within countries, grant ODA for water and sanitation should be directed to regions, settlements and social groups where public subsidy is necessary. Within the water sector, ODA should also be used for services which have to be financed publicly because it is not feasible to provide them privately, such as water resource management, large water storage schemes, flood control, and major irrigation and drainage projects.

Bilateral ODA should also support various current important multilateral initiatives, such as the African Water Initiative, African Water Facility, AfDB's Rural Water Supply and Sanitation Initiative, and the FAO's Special Programme of Food Security, amongst others. Rather than funding entire projects or programmes, and smothering local initiatives through indiscriminate subsidies, aid donors should regard their funds as catalysts to mobilise other flows, empower other players, and encourage self-sufficiency. Aid should be used to cover initial overhead costs, equity for revolving funds, guarantees, and for targeted subsidies and output-based aid delivered according to results.

Donors should report annually about the impact of their aid on achieving water MDGs by publishing a) the number of people they have helped to gain access to water and sanitation; b) the average 'aid efficiency' ratio of their water projects, namely, the above number of people served divided by the grant value of their aid, and, c) the 'leverage effect' of their aid, namely,the total amount of financing mobilized on water projects they have aided.

Multilateral Finance Institutions (MFIs)
MFIs such as the World Bank Group, the regional development banks and the European Investment Bank are crucially important because of the volume of their funding and the leverage effect it has on other flows. MFIs would be expected to substantially increase their contributions to the water sector. Those MFIs which do not at present lend to sub-sovereign entities should reconsider their policies, with the aim of permitting such lending in appropriate cases, subject to normal prudent lending criteria.
MFIs should revise their policies on capital provisioning, where these are constraints or disincentives to the use of guarantees. Those MFIs subject to the participation requirement should consider amending their articles to enable them to have the freedom to issue guarantees on a standalone basis, unrelated to actual loans made.

Because of the large unmet needs for water storage, MFIs and donors should resume lending to essential surface and underground water storage projects, subject to social and environmental safeguards

International commercial lending
The panel's recommendations are addressed to several of the major constraints to private lending. In particular the Report considers sovereign risk, foreign exchange

risk, the heavy preparation costs of project finance, and the minimum threshold size of project financings caused by the specific costs of structuring and the restrictive OECD consensus rules on export credit.
The panel recognised the benefits of banks developing a track record and creating a market precedent in water projects, and of developing local capital markets, and enhancing and extending sovereign risk coverage from both MFIs and ECAs.

The panel is concerned that the future viability of commercial bank project finance lending to the water sector might be adversely affected by new BIS capital weightings under the Basel II 'New Capital Accord' – which will be issued later this year. These developments should be closely monitored.

Export Credit Agencis (ECAs).
ECAs are urged to set targets for their water sector business, to lengthen the maturities for water loans and increase the proportion available for local costs. They should also consider offering guarantees and loans in local currency.

Private investment and operation
Private investment does not just include that from large international operators. It also comes from local investors in all parts of the sector, at all levels. Governments and water authorities should recognise the present and potential role of the local private sector, and provide a legal framework which can encourage greater long-term investment from this source. Governments should include small scale local operators in their national water supply strategies and service development plans, including incentives for them to improve their services, and they should receive better access to finance.

The prospect of private sector participation (PSP) in its various forms can be a powerful spur to the reform of public water agencies, whether it actually happens or not. In situations where reforms are being considered or tenders of various kinds are being drawn up, private participation should be included as an *option*, to be decided on specific grounds of efficiency, cost and effectiveness. Contract and procurement decisions should, as a rule, be made through open and transparent competition, typically on the basis of bidding.

The panel believes that water projects can be financed by combining public funds with private financing in transparent and acceptable ways. Public money can be used to stimulate projects for benefiting the general population without granting undue benefits to private parties. ODA and MFI lending should be available to facilitate water projects managed by private operators under public control, e.g. use of output-based aid to expand networks or fund revenue shortfalls on a diminishing basis under a concession. Alternatively, ODA could be used to finance investment in assets owned by the public and operated by the private sector.

A devaluation liquidity backstopping facility is proposed to address the devaluation risk for public and private sector promoters and operators taking on foreign currency commitments. As already noted, a Revolving Fund is proposed, addressed to the problem of the large fixed costs of preparing PSP contracts and tenders.Guarantee and insurance schemes offered by MFIs, governments and export credit agencies should be expanded in scope and internal constraints on their use should be relaxed.

Governments taking up options granting PSP concessions should provide adequate safeguards in order to create investors' trust and confidence in the sustainability of long-term contracts and the revenue streams they define.

Community initiatives and Non-Governmental Organisations (NGOs)
Local communities need to receive the powers and resources necessary to enable them to perform their important role. Support from local NGOs, with backing from their international counterparts, is often crucial. In addition to the ordinary operations of local commercial banks, micro-credit schemes are important in financing community water projects and small local producers, and they should be supported by donors, MFIs, banks and external NGOs through the provision of seed capital, initial reserves and guarantees. On-going subsidies should be avoided.

International NGOs should propose ways of raising more funds through the various kinds of solidarity mechanisms. The panel proposes that a full study be conducted of the feasibility of creating Decentralised Funds for the Development of Local Initiatives.
Building the capacity of different local and national civil society stakeholders to perform independent watchdog roles is important in tracking the performance of public and private bodies and tackling corruption in the sector.

6. Conclusions: priorities, actions & impacts

The proposals differ in their nature, and in the speed with which they can take effect. They should be prioritised, with first priority given to producing action programmes, followed by the greater use of existing schemes and tools. Study should begin of new proposed methods, and a start should be made on the more difficult reforms.

The panel addresses its recommendations to seven different "actors":

Central governments, in both developing and developed OECD countries;
National bodies at regional and local level
Community organisations & service-oriented NGOs
Banks & private investors and operators
Aid agencies
Multilateral Finance Institutions
United Nations and other international organisations

The panel's intention has been to attempt a balance between the needs of different water sub-sectors. This has not been easy. Inevitably, because of the prominence given to reducing the service deficits of the poor in the MDG and Earth Summit, the needs of poor households have absorbed much of the panel's time. Each sub-sector requires its own distinctive approach, and many solutions are sector-specific. In particular, the financing needs of irrigation is a complicated problem which calls for deeper reflection and specific solutions.. With these reservations, the panel believes that its proposals would have financial benefits for each of the main branches of the water sector.

The panel envisages a three-phase strategy for implementing its programme for raising the flow of funds into the global water sector. Many proposals will need further study and elaboration by the parties involved. The Kyoto Conference is an ideal opportunity for the various parties identified in this report to start work on their respective proposals. Subsequent high-level meetings in 2003, e.g. the Development Committee and the G8 gathering, will be the occasions for keeping up the momentum. The panel is aware that the current time is highly fortuitous for implementation of the proposals in this report, and urges all parties involved to maximises the synergies that are there to be exploited.

The panel's implicit perspective has been the 21 years remaining before 2025, with 2015 the interim stop. After Kyoto a good opportunity for checking progress would be the Fourth World Water Forum scheduled for 2006. By then, most of the necessary measures proposed in this report should have been taken, and results should be starting to appear.. We recommend that progress in implementing our proposals should be evaluated at that time. This would be the first strategic phase in the implementation of our report.

The next obvious check-point is 2015, and the period from 2006 to then would constitute the second phase of implementation. The third phase would be from 2015 to 2025, when the aim would be universal coverage for water and sanitation and global water security in its wider sense.

Progress towards achievement of the MDGs should be systematically monitored by a global "control tower" consisting of a reporting network and an independent committee of "wise persons". Existing systems for collecting and reporting data on global water should be reformed, strengthened, and coordinated, as appropriate. Information on progress towards the water MDG targets, and the performance of the many parties involved in implementing and funding this effort, should be produced. The data would be evaluated by a group of "wise persons" who would make recommendations on the steps to be taken to secure the water MDGs.