TECHNICAL BRIEF

USAID'S WATER, SANITATION AND HYGIENE FINANCE (WASH-FIN)

ASSESSMENT OF THE KENYA POOLED WATER FUND: EXECUTIVE SUMMARY (DECEMBER 2021)

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BACKGROUND

The Kenya Pooled Water Fund, (KPWF) was established in 2017 as part of the Dutch government's interest in expanding the pool of available financing beyond that available from government and development partners who have been the main sector financiers. The Government of Kenya estimates that the country needs to invest KES 100 billion (USD 930 million) annually if it is to meet the goal of universal access to water by 2030[1]. Yet as of 2018, only about KES 40 billion (USD 370 million) was available annually, leaving a total shortfall of KES 600 billion (USD 5.6 billion) [2] to achieve universal access to water by 2030. Filling this gap will require significant new forms of investment from public and private sources.

KPWF planned to arrange USD 100 million from the local capital market to finance several water and sanitation projects for the period 2018-2022[3]. The KPWF bond product was designed as a series of loans targeting between USD 30 and 50 million annually, with an average tenor of 15 years and a fixed interest rate of about 15% per annum. To protect from bond default, the KPWF required guarantees at two levels, a liquidity guarantee, and a default guarantee. Through the National Treasury, the Government of Kenya provided USD 2.5 million in the 2016/2017 national budget and set up a reserve account with the Water Sector Trust Fund (WSTF), the government's WASH financing entity. USAID, through the Investment and Economic Opportunity (IEO) provided a partial credit guarantee facility through the Development Credit Authority (DCA)[4]. The Swedish International Development Cooperation Agency (SIDA), through GuarantCo, provided an additional guarantee to de-risk the loans. The IEO also provided early support in evaluating the KPWF proposal and making recommendations. At later stages, USAID provided technical support to KPWF through the Kenya Integrated Water Sanitation and Hygiene (KIWASH) and the Water, Sanitation and Hygiene Finance (WASH-FIN) programs.

KPWF planned to issue the first bond of USD 50 million in the last quarter of 2017, but it did not materialize. The timing of the bond was postponed at least six times between 2017 and 2019 and the amount was also revised several times. On May 13, 2019, KPWF formally requested USAID to terminate the DCA guarantee, a signal that the execution of the bond would take even longer. USAID formally terminated the guarantee on June 11, 2019. The other guarantee with GuarantCo and SIDA was never executed as there was no bond issuance. At the time of this assessment, KPWF had still not been able to fulfill its original mandate.

USAID sought to gain a better understanding of the challenges the KPWF process faced and the contextual realities that made implementation difficult. USAID was particularly interested in understanding its own role in the KPWF including if it could have done anything differently that could have contributed to a different outcome and how to better support such efforts in the future.

USAID's assessment sought to answer five key questions:

i. Was the rationale behind KPWF solid?
ii. Was the structure of KPWF the most optimal for the targeted environment?

1 Ministry of Environment Water and Natural Resources, Republic of Kenya (2013). National Water Master Plan 2030, Final Report.
2 Kenya Water Services Regulatory Board (2019). Impact: A Performance Report of Kenya's Water Services Sector – 2017/18.
3 Information from feedback provided by the Dutch Embassy.
4 The DCA used to be part of USAID but has been transferred to the U.S. International Development Finance Corporation (DFC).

iii. Was the assessment of market readiness, correct?
iv. Was the product being offered comparable to what was already in the market?
v. Was government and other stakeholder engagement sufficient to enable the process?

The assessment was carried out by USAID's WASH-FIN activity between January 2020 and November 2020[5] and interviewed at least 20 people representing national and county government officials, water service providers (WSPs), development partners, and technical support staff from different entities. The project collected other data based on review of documents and materials from various meetings and discussions between USAID's WASH-FIN activity team, USAID, and KPWF.

FINDINGS

The rationale behind KPWF was solid. Well before KPWF, as far back as 2013, it was recognized by all stakeholders that the financing gap in the water and sanitation sector was too large for the public sector to close alone and there was thus a need to bring in private financing. Kenya is classified as a lower middle-income country, which strengthens the need for private financing[6]; increasingly, the country would have less access to concessional loans and grants and would have to rely more on alternative and private sources of financing for its developmental programs, including for WASH. Efforts to bring commercial finance to the water sector were therefore already underway prior to KPWF. For example, the World Bank, working jointly with the USAID's Sustainable Water and Sanitation in Africa (SUWASA) project, were already supporting WSPs to access commercial financing from the local banks through the Output Based Aid (OBA)[7] program. By the close of SUWASA in 2015, six WSPs had borrowed approximately USD 3.2 million[8]. By 2019, nine WSPs had borrowed a total of Ksh 767 million (USD 7.7 million) from three commercial banks[9].

On the supply side of capital, the conceptualization of KPWF was spurred by the fact that the domestic capital market in Kenya was, and still is, one of the most developed markets among Eastern and Central African countries. Therefore, national government stakeholders and development partners welcomed the KPWF approach. The KPWF product would increase the ticket size and volume of transactions by pooling available resources from the capital markets and further provide longer tenors, ultimately lowering the financing costs for the borrowers. KPWF was designed to augment efforts to increase access to private financing.

The structuring of KPWF was optimal for the targeted environment but created its own challenges. As a legal entity, the structure of KPWF as a trust looking to borrow from potential investors made sense as there were no funds available to provide seed capital to start the lending. To make the sector attractive to potential investors and given the fact that most WSPs could only potentially take out relatively small loans (average USD 4 million for the larger WSPs[10]), the decision was made to 'pool' the loan portfolio receiving financing from the KPWF. The pool included approximately 5 to 15 WSPs for

5 This Executive summary was prepared between November and December 2021, following numerous conversations and final agreement between USAID and the Dutch Embassy in Kenya.
6 https://datahelpdesk.worldbank.org/knowledgebase/articles/906519 -world-bank-country-and-lending-groups
7 https://www.gprba.org/sites/gpoba.org/files/GPOBA_fact_sheet_english_0.pdf
8 https://www.globalwaters.org/resources/assets/wash-fin/kenya-project-brief
9 Results Based Financing for Water and Sanitation Investments in Kenya. Presentation by WSTF at the WASREB and WASH-FIN Knowledge Exchange Event for WSPs, held on 18 and 19 February 2020.
10 Most WSPs were and still are not creditworthy and cannot therefore take on large ticket size loans. Further, the initial loans under SUWASA and the OBA, were largely targeted at service improvements in low-income settlements and not large infrastructure. There was also a limit on funds available for subsidies under both OBA and AoD thus limiting the loan sizes.

each annual bond issuance. However, it was exceedingly difficult to get a 'firm pool of WSPs' at any one time due to numerous factors, including: limited number of creditworthy WSPs, lack of a ready project pipeline, governance issues faced by the few creditworthy WSPs, and competition amongst development partner programs targeting the same creditworthy WSPs for different commercial and concessionary loan products.

Another challenge on the demand side was the long standing and unresolved issue of unpaid water sector debts which stem from largely sovereign loans procured through the former regional Water Service Boards (now called Water Works Development Agencies) with the expectation that the WSPs would repay the loans through the sale of water and sanitation services. WSPs cannot afford to pay these loans which increase their lack of creditworthiness. They therefore needed these loans to be restructured, for which there is currently no clear agreement on how, when and if this may happen.

The idea of a reserve account was put forth to protect potential investors and to facilitate the WSPs to take the available funding upon deal signing. However, if WSTF issued junior bonds through the reserve account, it would be against Kenya's Public Finance Management Act. The fact that the decision to host the reserve account at WSTF was only rescinded in January 2019[11], three years after the start of KPWF, contributed to significant delays and uncertainty amongst key stakeholders on the efficacy of the KPWF.

KPWF's assumptions on the readiness of WSPs to take on debt were too optimistic. Prior programs including the World Bank's OBA and USAID's SUWASA and KIWASH had already established that the problem of accessing private financing had little to do with the supply of money and more to do with the readiness of the WSPs to borrow[12]. The financial weakness of potential borrowers and the challenging governance environment in which WSPs operate made it difficult for KPWF to achieve a project pipeline.

The KPWF product was comparable and in some respects superior to what was already in the market. *In* terms of ticket size, cost, maturity, de-risking, project management and implementation, the KPWF product was superior to other financing options available. Whilst the 60 percent subsidy given by the OBA makes the loans cheaper, the KPWF product must be seen in the broader perspective of the growth of the WSPs and the needs of the sector. This is because OBA loans are limited in size and can only apply to projects that prioritize low-income areas. The size of the KPWF loan, on the other hand, depends on the need and creditworthiness of the WSP and could be used to develop any infrastructure prioritized by the WSP. Sustainability of the OBA funding is uncertain, as it depends on the goodwill of external partners. Conversely, if successful, the KPWF could bring a sustainable source of local funding for potential access by many more WSPs.

KPWF could have benefitted from a comprehensive framework for engaging all relevant stakeholders. KPWF succeeded in obtaining higher levels of national government interest as evidenced by the buy-in from the National Treasury to set up the reserve fund. However, the assessment also showed different stakeholders engaged in the process as it evolved, rather than being co-creators from the onset. For example, provision of technical assistance to WSPs for preparation of projects and financial analysis for debt capacity came in through USAID's WASH-FIN, Kenya Markets Trust and Design to Build (D2B) the latter two funded by

11 In January 2019, the Attorney General advised WSTF that they could not issue a junior bond under the KPWF.

12 WASH-FIN Kenya Project Brief – Access to Commercial Finance for WASH in Kenya | Globalwaters.org

SNV at later stages. Similarly, engagement of USAID, SIDA, the Department for International Development (DFID, now the Foreign, Commonwealth & Development Office) also came later in the process. WSTF, which was to anchor the reserve account and therefore a critical element for the success of the program, stated that they were not adequately consulted.

The assessment also found that lack of government visibility in the process affected local ownership and resulted in failure to sign two key documents necessary to operationalize the KPWF. These are the ***Framework Arrangement*** between the Government of Kenya and the Government of the Netherlands, and the ***Implementation Agreement*** which the Ministry of Water Sanitation and Irrigation, the Council of Governors, the Water Sector Trust Fund, and KPWF were expected to co-sign.

In addition, the reliance on external consultants - who were not based in-country and were procured and paid for by the Netherlands - made the process look overly donor driven (perceived and otherwise) and contributed to the difficulty in enshrining the needed level of ownership and commitment by local stakeholders. The lack of visibility of the Government of Kenya during the process reinforced that perception, making WSPs wary of committing to the process.

RECOMMENDATIONS

ENHANCING GOVERNMENT LEADERSHIP IN THE PROCESS

The government must reassert their leadership of the process. There are five perspectives to consider in viewing this leadership:

i. Build a comprehensive sector financing framework. KPWF was not the only mechanism looking to bring in non-traditional financing to the sector. Other development partners considered and developed similar mechanisms. As Kenya had been declared a lower middle-income country, all the traditional lenders including the World Bank, African Development Bank (AfDB), and the German Development Bank (KFW) were looking for ways to diversify their lending to sub-sovereign entities and acquire required funding. However, the lack of a comprehensive financing framework for the sector meant that there was no coordination of these efforts, leading ultimately to split interests for the WSPs, which forced them to 'choose' the best options. From the USAID's WASH-FIN experience, most WSPs took time to explore the possibility of exhausting 'cheaper' options first and only choosing KPWF as a 'last resort.' A comprehensive financing framework for the sector that allows different financing options and sources, including the KPWF, government transfers, sovereign loans, and other lending programs, to be applied to the most relevant parts of the sector would help in coordinating various efforts by development partners and avoid a scenario where WSPs are pulled in different directions.

ii. Finalize ongoing conversations on the role of WSTF. This discussion must look beyond the immediate needs of KPWF and provide guidance on how WSTF can play a role that allows all the existing mechanisms, including KPWF, OBA, Aid on Delivery (AoD) and Performance Based Financing, to be combined and ensure a comprehensive financing framework that takes advantage of existing public resources to optimally leverage private sector resources. Financing is required not only for the most successful WSPs that are the targets of all the current private sector initiatives, but also for the weaker WSPs, especially those serving the underserved and rural populations. The goal of achieving universal access must be the driving force rather than the success of one or other financing mechanism.

iii. Address the issue of Existing Water Sector Debts. The national government needs to address this issue through a transparent framework agreed upon by all parties, and which allows all WSPs to benefit from any potential relief or rescheduling of this debt. A national-level restructuring could potentially provide space for more WSPs to access commercial financing, including from KPWF.

iv. Ensure a closer working relationship with WASREB. This will help to mitigate potential investor concerns over timely tariff reviews, a key driver of WSP cash flow positions. Part of the KPWF process proposed tariff indexation by the regulator to support the commercial financing process. When implemented, tariff indexation smooths tariff increases and enables WSPs to better predict cash flows to support loan repayment.

v. Address governance and intergovernmental challenges. For all the above to be effective, sector governance must be addressed. It is imperative for government to devise ways to provide counties and WSPs with guidance on governance best practices to improve buy-in from management and the county governments and reduce the risk of default on projects. This also calls for greater focus on the intergovernmental relationship challenges which tend to pit the two levels of government against each other, creating an atmosphere of mistrust and stagnation.

RESTRUCTURING KPWF TO FIT SECTOR STATUS

The limited creditworthiness of the WSPs and the ongoing sector restructuring due to devolution may mean more time for the WSPs to adjust and stabilize before they may be ready to borrow in larger numbers. In addition, ongoing collaboration between the World Bank and USAID's WASH-FIN in supporting the financial recovery of WSPs from the impact of the COVID-19 pandemic, highlights that WSPs will take some time to recover and will require public sector support. Therefore, restructuring of the pooled fund so that it begins more as a revolving fund with contribution of some public funding will allow for cheaper loans and improvement of WSP creditworthiness. The proposed restructuring would also address a major challenge of seed capital which was dependent on issuing a bond to investors and then lending this money to a pool of WSPs.

CLEAR GAUGING OF INVESTOR APPETITE

Bond issuances during the period under assessment indicated that the level of appetite from investors was still rather low and raised the question of whether the water sector would be attractive to investors in the capital markets. The profile of the bonds is highly dependent on the creditworthiness of the WSPs, yet various assessments have shown that only about seven to nine WSPs in Kenya are creditworthy. It would be important for USAID and other development partners to ensure that there is clarity and sufficient understanding of the position of prospective investors, vis-à-vis their perceptions on financial viability of such a fund.

COMPREHENSIVE STAKEHOLDER ENGAGEMENT

For a process such as KPWF to work effectively, it requires that all stakeholders not only know what is being proposed but are able to influence the process. A process for co-creation with other stakeholders would allow for the entire process to be well articulated from start to finish and agreed upon by all parties on all the different elements on both the demand and supply sides.

USAID ROLE

The USAID guarantee provision of the DCA was a real commitment to advancing new approaches to financing the water sector in Kenya. The provision of technical assistance through both its KIWASH and WASH-FIN programs further enhanced their commitment. However, the engagement with KPWF lacked a platform or clear strategy for learning and influencing of KPWF in a deliberate and systematic manner. A hands-on approach by USAID through WASH-FIN and KIWASH engagement would have added value in structuring of the technical aspects of KPWF as both USAID programs were deeply engaged with the WSPs and counties and therefore had an in-depth understanding of the situation in the water sector.

Lastly, USAID (and the other parties offering guarantees) should have been part of the Steering Committee helping to shape the discussion and outcome of the process, rather than only providing specific inputs at the request of KPWF.

PROJECT DETAILS

The WASH-FIN project is funded by the United States Agency for International Development (USAID); it began in October 2016 and concludes in 2022. Implementation is led by Tetra Tech with support from Open Capital Advisors, SEGURA Consulting, and Global Credit Rating. Focus countries include Cambodia, Nepal, Philippines, Kenya, Mozambique, Senegal, South Africa and Zambia. For more details, visit https://www.globalwaters.org/WASH-FIN.

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