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GRIDLINES

Sharing knowledge, experiences, and innovations in public-private partnerships in infrastructure

Helping a new breed of private water operators access infrastructure finance

Microfinance for community water schemes in Kenya

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Small-scale providers of water services are no longer seen as merely temporary substitutes for formal utilities. In many developing countries governments and donors increasingly view them as long-term partners in the work to extend and improve water services, particularly as governments accelerate efforts to meet water targets associated with the Millennium Development Goals. But a host of problems complicate efforts to make small-scale providers productive partners, including their lack of access to finance. In Kenya, a collaborative program is bringing together community-based organizations and microlenders to provide better water services to poor people—and generating lessons for similar initiatives.

In Kenya, the government has made a determined effort to partner with small-scale water providers. It has already put into place a basic legal and regulatory framework to support this effort. Donor organizations have joined in, developing, funding, and managing innovative pilot programs to generate and test hypotheses about the best ways to support small water providers.

One such program, now being rolled out in 21 communities, brings together the government, a Kenyan microfinance institution, local community-based organizations (CBOs), and several multidonor trust funds. Managed by the World Bank, these trust funds include the Water and Sanitation Program, the Global Partnership on Output-Based Aid (GPOBA), and the Public-Private Infrastructure Advisory Facility (PPIAF). The program has already generated important lessons for engaging small-scale providers in delivering water services to poor people.

Small-scale providers: here to stay?

For decades small-scale water providers were seen as temporary sources of inferior services whose high prices and lack of health and safety measures called for replacement by formal utilities. But today governments in many developing countries view small providers as a practical way of serving low-income households and dispersed populations in rural and periurban areas.

In most cases this new perception is simply a recognition of what is already taking place. A recent survey identified 23 African countries where small-scale providers are supplying different kinds of services (Kariuki and Schwartz 2005). In at least 11 of them such providers account for a significant share of water services. And given the scarcity of documented evidence, the numbers probably capture only a small fraction of the population of small-scale providers.

In Nairobi the picture is a little clearer. Community management of water schemes was introduced in both rural and urban areas in the 1980s, and today CBOs or small companies serve at least 60 percent of Nairobi households. Indeed, in Nairobi's large urban slums CBOs or informal neighborhood groups are typically the only providers, because residents have no legal tenure and therefore cannot be served by formal utilities.

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Small-scale providers typically lack both access to finance and the capacity to use it well

In rural areas, home to 70 percent of Kenya's population, about 30 percent of water schemes have been handed over to or set up by CBOs. The number of such operations—especially those that can serve both domestic and irrigation needs—is expected to grow. In periurban areas domestic demand for water services from small providers is already growing rapidly as urbanization accelerates.

Yet CBOs and other small-scale service providers have well-documented weaknesses, and many of these are evident in Kenya. These providers typically lack both access to finance and the technical and managerial capacity to use finance effectively. They also face resistance from formal public utilities, lack legal status or tenure, and provide services that are largely unregulated in terms of both price and quality.

Kenya has already made progress on some of these fronts. To deal with the unclear legal status, resistance from utilities, and lack of regulation, regional water boards—which generally own water service assets—are working with small providers to help them gain legal status as companies or associations. They can then operate as independent service providers under Kenyan law and enter into service provision agreements with the boards. These agreements regulate prices and service quality.

The role of microfinance

The biggest challenge facing CBOs is their lack of access to finance. They often must save for years for the initial capital investments if they need to lay pipes, buy pumps, dig a borehole, or construct storage tanks. Often the only sources of credit are family loans, community savings groups, or informal moneylenders who charge exorbitant interest rates.

In a country such as Kenya microlenders are the logical source of finance for CBOs and other small providers of services. Microlenders can be anything from community-based revolving funds to commercial banks that provide a full range of normal banking services to low-income clients. The modern microlending model, generally traced to Bangladesh's Grameen Bank, established in 1976, centers on "solidarity loans." These put less emphasis on credit assessments or pledges of collateral for individual borrowers, instead involving small groups of borrowers who vouch for one another and ensure repayment through peer pressure.

In Kenya microlenders are licensed and have relatively wide outreach. While only 10–15 percent of the poorest families across Africa have access to microcredit, in Kenya the share is estimated to be about 30 percent. Nevertheless, even Kenyan microfinance institutions typically do not lend money for infrastructure projects such as small-scale water schemes. Microlenders do not understand the water sector, prefer not to make long-term loans (required for even small infrastructure projects), and have little interest in or understanding of project finance loans (backed only by project revenues).

Moreover, because the financing would be done as single loans to CBOs rather than individuals, solidarity lending would be less effective. So would repayment measures now used in urban areas, such as automatic payroll deductions. Instead, microlending to CBOs would require project credit analysis, something with which most microlenders are unfamiliar.

Microlenders are also resistant to lending to CBOs out of a legitimate concern that they often lack the technical and managerial skills to design and supervise the construction of facilities that can be run efficiently on a cost-recovery basis. Small local water systems tend to be either overdesigned and too expensive or designed in ways that seriously underestimate demand growth. And private sector entities offering finance or advisory services helpful to fledgling businesses do not understand CBOs or the water supply business and often are uncomfortable with small-scale project finance.

Bringing the two together in Kenya

A partnership of multidonor trust funds is working with the Kenyan government, local CBOs, and a Kenyan microlender to help CBOs access microfinance for small water projects. The Water and Sanitation Program designed the initiative based on its work since 2003 to understand the potential demand for and supply of finance and technical services associated with small-scale water provision in Africa.

In early 2005 PPIAF financed, and the Water and Sanitation Program managed, a study that looked more closely at the capacity needs of CBOs and the possibility of market-based financing of small water operations. The study also investigated business models for combining donor subsidies with private sector finance and technical assistance to

BOX 1

Some community-based water projects in Kenya

Kerarapon. **With a population of about 2,500, this community is located just outside Nairobi. The community relies on water from a spring, piped to nearby households, but needs about US$80,000 for more pipe network, storage tanks, and a backup pump to connect new customers. The scheme is run by a community-based organization that has mapped out a way to make the project viable with community contributions, loan funds, and a subsidy from the Global Partnership on Output-Based Aid (GPOBA).**

Kamandurra. **Located just outside Nairobi, this community consists mostly of small dairy farmers, forced to purchase water from vendors at exorbitant rates. The community raised funds to commission a technical design for a groundwater-based system that could provide water for domestic and livestock needs. The project would cost about US$105,000. Now the community is raising funds to meet its share of the costs and to match a commercial loan along with a later GPOBA subsidy. The possibility of links with a dairy where most farmers daily sell their milk increases the comfort level of lenders.**

Kanunga. **This community has managed to revive a failed water system through contributions from members and fund-raising. It offers limited water to some residents through kiosks and individual connections. But because of poor technical construction there is water loss and the project fails to collect revenue for all the water produced. The community management group needs US$70,000 to rehabilitate some parts of the system so that the project can collect more revenue, reduce costs, and add new connections. The proposed investments should improve access to water services for the entire community and for livestock, helping to increase income from milk sales.**

New tools can help microlenders appraise small-scale water projects

help CBOs expand and improve their water delivery operations.

The study led in 2006 to a successful application to GPOBA for technical assistance funds to develop a pilot output-based subsidy program managed by the Water and Sanitation Program. The program will facilitate market-based infrastructure finance for 21 CBO water providers in rural and periurban areas of Kenya. The partnership between the three trust funds has already generated some key lessons:

- Microlenders need new tools to deal with CBO water projects.
- CBOs need greater capacity to operate like businesses.
- Subsidies can be used to kick-start partnerships between CBOs and microlenders.

Providing new tools for microlenders

Microlenders that want to identify market opportunities and develop and appraise opportunities for lending to CBO water projects face high initial transaction costs. Most have much to learn before they can manage such lending prudently.

To help address this problem, new assessment tools that lenders can use to appraise small water projects have been developed and tested (Mehta and Virjee 2006). One is an approach for industry assessments of small water projects in Kenya. A second is a set of 10 project assessment tools, organized as part of a typical microloan process, for assessing technical, financial, and community management viability. Some of these tools can be used for simple rapid assessments in the preliminary identification of projects; others for more sophisticated appraisals of formal loan applications. Yet another is a business planning tool that allows both CBOs and microlenders to assess the long-term financial viability of a water project.

Building capacity

Many CBO operations in Kenya are well run, with regular financial record keeping and policies for cash management. But most need support in developing viable investment and financial planning that effectively incorporates community consultation. Most will also need ongoing training and guidance in business planning for efficient operations that recover costs as well as help in preparing viable borrowing proposals and plans for managing debt service.

To help ensure that small water service providers can obtain the continued guidance and capacity-building support they will need, the Water and Sanitation Program is leading efforts to develop a local market in business development services. Each CBO applying for a capital investment loan as part of the pilot program will receive a small fixed subsidy enabling it to choose a prequalified business adviser whose services best fit its needs. This approach may help stimulate development of a sustainable local market in such services.

Kick-starting partnerships

GPOBA has added a final, critical building block to the program by helping to design and provide output-based subsidies to the 21 community-managed water projects. Each of these projects, selected through a transparent application process, will be prefinanced through community resources (20 percent) and a loan from a local microlender (80 percent). The lender, K-Rep Bank, will follow due diligence procedures enhanced with some of the appraisal tools.

Once a community project has generated its agreed-upon outputs, as confirmed by an independent audit, GPOBA will provide the community with a subsidy amounting to 40 percent of the total eligible project costs. The outputs can include such achievements as household water connections or kiosks and demonstrated water sales. The subsidy can then be used to refinance the loan, meaning that the community ultimately is responsible for 60 percent of total project costs.

Conclusion

CBOs and other small-scale service providers constitute a new breed of local private operators in the rural and periurban areas of many developing countries. They play an important role that will strengthen the water sector reforms urgently needed in many of these countries. But small providers can contribute significantly to efforts to expand and improve water supply, particularly for poor people. Helping small providers responsibly access market-based finance for capital investments adds an important dimension to their role. Combining support to microlenders with capacity building for CBOs and the judicious use of subsidies offers potential for bringing together community organizations and microlenders in a much-needed partnership.

BOX 2

Business development services for small-scale private providers

Small-scale providers typically lack the technical and managerial capacity to develop and implement projects that use bank financing. Support from business development services will help them with a range of tasks:

- ***Community mobilization*** **(initial planning, identification of the scheme, arrangements for community management and decision-making, financial commitments)**
- ***Business entity formation*** **(legal registration of the CBO where required)**
- ***Prefeasibility planning*** **(to identify the scope and cost of the scheme)**
- ***Financial assessment*** **(to establish the financial basis for the scheme, including projections of tariff levels)**
- ***Business planning*** **(to establish management arrangements, staffing, establishment costs, financial management arrangements, and the like)**
- ***Technical project design***
- ***Procurement of construction contractors***
- ***Construction supervision.***

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