SUSTAINABLE WATER AND SANITATION IN AFRICA (SUWASA)

Kenya Reform Work Plan -Innovative Utility Finance

June 30, 2013

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CONTENTS

ACRONYMS

AoD	Aid on Delivery
bfz	Berufliche Fortbildungszentren der Bayerischen Wirtschaft gGmbH (The Training and Development Centers of the Bavarian Employers' Associations)
CBK	Central Bank of Kenya
CIC	Constitution Implementation Committee
COP	Chief of Party
DAI	Development Alternatives International
DCA	Development Credit Authority
DFID	United Kingdom's Department for International Development
DIG	Development Innovations Group
GoK	Government of Kenya
HF	Housing Finance
IUF	Innovative Utility Finance
JICA	Japan International Cooperation Agency
KCB	Kenya Commercial Bank
KFW	Kreditanstalt für Wiederaufbau (German Development Bank)
KIWASCO	Kisumu Water and Sewerage Company
M&E	Monitoring and Evaluation
MDGs	Millennium Development Goals
MFI	Microfinance Institution
MIS	Management Information System
MoU	Memorandum of Understanding
MWI	Ministry of Water and Irrigation
NAWASSCO	Nakuru Water and Sanitation Services Company
NGOs	Non-Governmental Organizations
NRW	Non-revenue water
PSIF	Private Sector Investment Finance
RWP	Reform Work Plan
SANA	Sustainable Aid in Africa International
SIP	Small Investment Program
SME	Small and Medium Enterprises
SNV	Netherlands Development Organization
SOI	Statement of Intent
STTA	Short-term Technical Assistance
SUWASA	Sustainable Water and Sanitation in Africa
SWAP	Strengthening Water Association Partners
TA	Technical Assistance
TT	Tetra Tech
UPC	Urban Projects Concepts
USAID	United States Agency for International Development
VEI	Vitens Evides International
WASH	Water, Sanitation and Hygiene
WASREB	Water Services Regulatory Board

WSB	Water Services Board
WSP	Water Service Provider
WSTF	Water Services Trust Fund
WSTG	Water Services Technical Group
World Bank-WSP	World Bank - Water and Sanitation Program

PROJECT SUMMAR SHEET

Project Title	**Innovative Utility Finance (IUF)**
Country	Kenya
Location	Urban areas in Kenya
Overall Goal	To promote innovative reforms and sustainable financing that improve the commercial viability of utility companies and increase access to safe water and adequate sanitation.
Specific Objectives	1. To support utilities in identifying commercially viable projects and developing bankable financing proposals 2. To advise commercial banks in developing water financing products and the lending methodology for utilities 3. To assess market demand and affordability for water and sanitation services, and support community outreach and education programs related to utility investments
Project Duration	26 months
Total Budget	$2,400,000
Commencement Date	June 1, 2013
Sub-contracted Implementing Organization	Development Innovations Group (DIG)
Implementing Partners	Kenya Commercial Bank (KCB) Housing Finance bank Up to 8 urban utility companies
Key Project Implementation Staff	DIG staff including: Team Leader, Utility Finance & Credit Risk Specialist, Community Outreach/M&E Specialist, Finance Manager
Reporting Requirements	Monthly, quarterly, mid-term (12 months) and end project report
Project partner contribution	Utility partners: in-kind staff time and resources for project identification, analysis, planning, proposal development, implementation and community outreach. Financial contribution of approximately 20-25% of total project value. Bank partners: in-kind staff time for product development, staff training and product integration. Financing of projects. USAID DCA guarantee fee. Community: in-kind contributions of time and resources. Financial commitment for household connections projects.

1. INTRODUCTION

The SUWASA Kenya Innovative Utility Finance project facilitates commercial financing to utilities to improve the utilities' financial performance and increase the urban poor's access to safe water and adequate sanitation. The project is broadly designed to support financing for bankable utility investments that respond to the needs of the utility and its consumers including financing network extensions and rehabilitation, household connections, non-revenue water reduction and installation of energy-saving and renewable energy improvements, among others. With collaborating sector partners, SUWASA Kenya has identified investments of more than USD 36 million among 29 urban utilities.

In terms of financing partners, SUWASA Kenya will work with the largest bank in East Africa, Kenya Commercial Bank (KCB), which has signed a USD 3 million United States Agency for International Development (USAID) Development Credit Authority (DCA) guarantee for water financing. KCB and SUWASA Kenya will collaborate to develop a water financing product and lending methodology for utilities. Housing Finance bank will complete the process of securing a USD 6 million USAID DCA guarantee by September 30, 2013 and will partner with SUWASA Kenya along the same lines as KCB. Housing Finance bank has secured board approval for KES 380 million (USD 4.6 million) for water financing pilots. These two banks are eager to begin work.

By capitalizing on SUWASA Kenya's network, partnerships and experience in innovative water financing, this project will leverage private sector resources in urban centers throughout Kenya to increase the urban poor's access to clean, safe and affordable water and will serve as a model for larger regional initiatives in Africa. The proposed project will work with new utility partners[1] and commercial banks to meet the overall SUWASA goal of promoting innovative reforms and sustainable financing for safe water and adequate sanitation in Africa.

2. CONTEXT OF THE PROJECT

2.1 OVERVIEW OF SECTOR

Today, approximately 8.6 million people are served by 64 urban water services providers (WSPs)[2] in Kenya.[3] This represents 52 percent of the urban population within WSP service areas and 21 percent of the total population. The rate of urban water coverage has been growing at a rate of 5 percent over the last four years; however, the urban population is projected to grow from the current 11.5 million to 19 million by 2020[4] at about 7 percent annually, and is projected to grow to 44.3 million (67% of the total population) by 2030[5]. As a consequence, investments in water supply will need to rise more rapidly to expand services to a growing urban population if Kenya is to achieve its National Water Services Strategy (NWSS)

[1] This includes new utility partners and two existing SUWASA utility partners (KIWASCO and NAWASSCO).
[2] Utilities and WSPs are used interchangeably in this document.
[3] Water Services Regulatory Board. Impact Report 2012, Issue No. 5, A Performance Review of Kenya's Water Services Sector – 2010/11.
[4] Kenya Economic Update Edition 4, June 2011, the World Bank Group.
[5] Kenya Vision 2030 National Water Master Plan as presented by JICA in the May 2012 Interim Report.

target for access to safe water of 80 percent in urban areas and 75 percent in rural areas by 2015.[6]

The Water Act 2002 reforms have been the driving force to improve sector efficiency and performance in the last decade. The reforms created a new legal and institutional framework that separated water resources management and water services provision; separated policy and regulation; and decentralized functions to the regional and local levels through the establishment of semi-autonomous institutions. The Ministry was charged with the functions of legislation, policy and strategy formulation; sector coordination and guidance; monitoring and evaluation; and resource mobilization.

The sector reforms have received added impetus from the Millennium Development Goals, which set clear targets for increased access to services; the Kenya Vision 2030, which seeks to propel the country to a middle class economy; the Human Rights Declaration to Water and Sanitation, which upholds equal rights to access for all; and the newly adopted 2010 Kenyan Constitution, which is bringing about a devolved system of government.

According to the Ministry of Water and Irrigation (MWI) Annual Water Sector Review 2011-12 draft report[7], after a decade of implementing the Water Act, there are visible improvements in the sector, including:

- Increased consumer and stakeholder participation in the decision making processes;
- Increased pro poor orientation evidenced by the establishment of a pro poor, government-owned basket fund called the Water Services Trust Fund (WSTF);
- The establishment of a regulatory framework to ensure consumer protection and water resources protection and management;
- Socially responsible commercialization of water services[8];
- Improved monitoring and reporting of sector performance, hence strengthening mutual accountability and increasing public awareness; and
- Increased funding to the sector.

Kenya's water sector remains heavily donor dependent with approximately 40% (USD 140 million)[9] of the annual capital spending coming from the donor community with the government providing the bulk of the balance and the private sector playing a negligible role. In this regard, the following recent developments in the sector are also notable:

- In December 2011, the Water Services Regulatory Board (WASREB), in collaboration with World Bank–Water and Sanitation Program (World Bank-WSP) published, **Financing Urban Water Services in Kenya, *Utility Shadow Credit Ratings***. WASREB

[6] Kenya's MDG targets for 2015: population using an improved drinking water source – 75%, and population using an improved sanitation facility – 96%.
[7] As a member of the Kenya Water Services Technical Group, SUWASA Kenya provides information and feedback to the Ministry and other key sector stakeholders. The draft is scheduled to be finalized in February 2013.
[8] This refers to service provider agreements, water quality controls, environmental compliance guidelines, tariff controls and financial oversight, among others.
[9] 2010-11 GoK budget figures.

undertook the exercise with the aim of supporting access to finance from the domestic financial market. Of the WSPs assessed, 30% were found credit worthy and 37% showed potential to improve their credit ratings through relatively small improvements in financial and operating efficiency.

- Given the supportive regulatory climate for commercial financing, key sector actors have worked with WSPs with good shadow credit ratings to define potential investments of more than USD 36 million for pipe extensions, rehabilitation, household connections, non-revenue water reduction, treatment plants, billing systems, energy savings and renewable energy projects.
- There is practical experience in WSP financing, notably SUWASA Kenya's work to facilitate USD 260,000 in financing for WSP projects in Kisumu and Nakuru in 2012.

These achievements demonstrate that the sector reforms and the strategy to integrate commercial financing for WSP investments are taking shape. However, it is important to note that utilities still have a limited absorption capacity for debt and that credit enhancement mechanisms (like the DCA guarantee and output based incentives) will continue to play a role in the short to medium term.

2.2 CURRENT SECTOR CHALLENGES

According to the MWI Annual Water Sector Review 2011-2012 draft report, the current sector challenges include:

- The continuous need for capacity building both at the institutional and individual level;
- Poor compliance of sector institutions with the Corporate Governance Guidelines;
- Continued subsidization of institutions that are economically unviable, such as small water companies;
- Rapid increase in population that continually places pressure for commensurate measures to increase infrastructure development for services provision.

The MWI draft report also includes a discussion on the Transition Plan to adapt the water sector reforms of the new 2010 constitution. This is discussed in the Assumptions and Risks section.

WSP Challenges

The Water Act 2002 shifted the management of water and sanitation services from the Municipal Council to commercial companies (WSPs) charged with utilizing acceptable business principles in their operations.[10] The specific WSP challenges addressed by this project include:

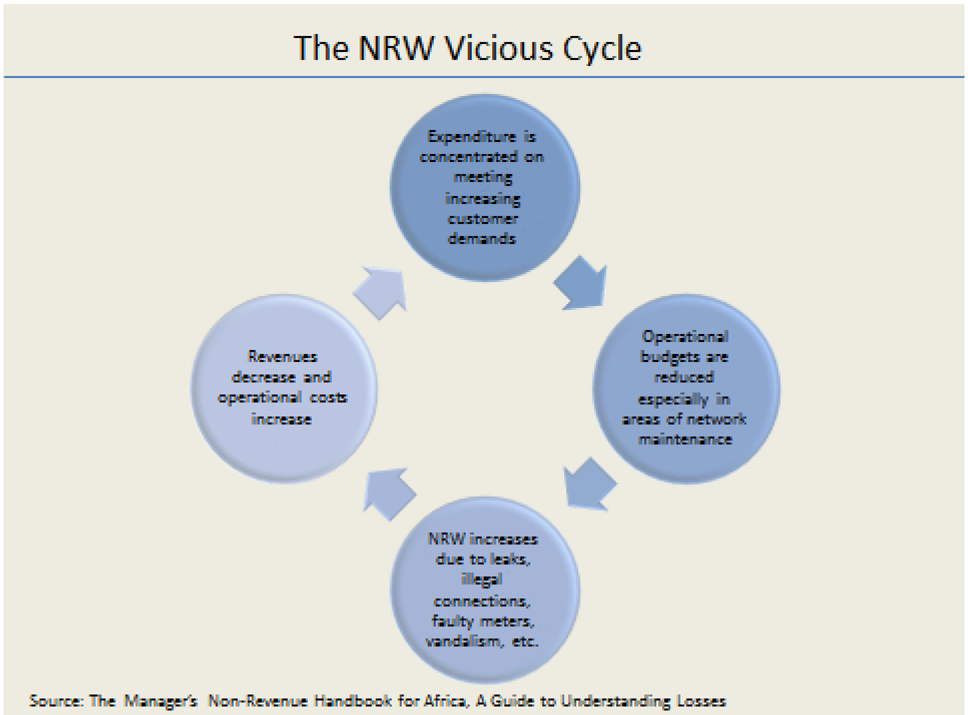
Integrating business principles. WSPs are still in an embryonic stage when it comes to core business practices like market assessment, financial analysis, cash flow projections, business planning, and investment financing proposals. The SUWASA technical assistance will address these areas and more.

[10] The Municipal government owns 99% of the company but has only three seats on the board of directors. All profits derived from the company must be reinvested until total water and sanitation coverage is achieved. The regulator has mandated that no politician may serve on the board of directors, but not all WSPs are compliant.

Financial autonomy. WSPs suffer from a lack of financial autonomy. The primary vehicles for WSP investments are government and donor grants. This process is long, uncertain and expensive in time and resources. It also makes strategic planning and business planning extremely difficult. Sustainable financing enhances autonomy and supports the transition to commercial viability.

Non-revenue water (NRW). The average non-revenue water loss for urban WSPs in Kenya is 45%.[11] The National Water Services Strategy target is to reduce non-revenue water to 30% by 2015. In a water scarce country where water is often rationed in urban areas, addressing this issue is critical for WSP sustainability and increasing access. The vicious cycle of NRW below is illustrative.[12]

FIGURE 1: THE NRW VICIOUS CYCLE



Rising energy costs. The primary operating costs for WSPs are personnel, chemicals and electricity. Electricity is typically the largest expense and, with rising prices, the costs have a significant impact on WSP financial performance. Kenya is also experiencing an energy crisis caused by drought and delays in implementing power generation and distribution projects, which has led to electricity rationing. This situation has led WSPs to look for ways to reduce energy use and to explore alternative energy sources like more efficient motors, mini-hydro and bio gas.

Banks

The potential for increased private sector participation is evidenced by SUWASA Kenya's work with K-Rep Bank, Family Bank and now Kenya Commercial Bank. As noted in *Potential Funding Options in the Water Sector*, "the banking sector, despite the political fluidity, seems to be willing

[11] Impact Report 5.
[12] The Manager's Non-Revenue Water handbook for Africa, A Guide to Understanding Losses. USAID and World Bank Institute. March 2010.

to provide financial resources to the current utilities on the basis of the income streams that are accruing to those utilities that are credit worthy."[13] While the appetite to finance bankable proposals is present, the current challenges for banks related to the water sector are as follows:

Product development and methodology components

- Strategic risk analysis
- Business risk analysis
- Target market and risk analysis
- Investment returns, pricing and risks (profitability analysis and liquidity analysis)
- Legal, regulatory and tax compliance and risks
- Outsourcing and third party risks
- Anti-money laundering / Know Your Customer compliance and due diligence
- Documentation requirements
- Implementation methodology

Product development and methodology. As a new product, the bank will need to map the operational risks and regulatory compliance of the new product using the criteria shown in the box below.

Regulatory risk. This is particularly important during the transition to the new constitution, e.g. ensuring that loan agreements include a "successor in title" clause if there is an ownership change at the WSP level.

Given the absorption capacity of utility companies and bank lending norms, individual project financing in this project is expected to be for terms of five to ten years and for amounts up to KES 100 million (USD 1.1 million).

3. DETAILED PROJECT DESCRIPTION

3.1 OVERALL GOAL

To promote innovative reforms and sustainable financing that improve the commercial viability of utility companies and increase access to safe water and adequate sanitation.

3.2 SPECIFIC OBJECTIVES

1. To support utilities in identifying commercially viable projects and developing bankable financing proposals
2. To advise commercial banks in developing water financing products and the lending methodology for utilities
3. To assess market demand and affordability for water and sanitation services, and support community outreach and education programs related to utility investments

3.3 ACTIVITIES

3.3.1 INCEPTION PERIOD

The Inception Period report will provide further detail on the schedule of activities and sub-activities under each objective. During the inception period, DIG's project implementation team will consult with SUWASA, USAID and key stakeholders, and assess new developments in the sector that may impact the project. The inception report will contain the following:

- Updated information relevant to the project since the due diligence assessment;
- Working procedures with key partners, particularly including preparation of memorandums of understanding (MOUs) as may be required;

[13] Potential Funding Options in the Water Sector. Market Assistance Programme-Kenya. Adam Smith International. Johan Kruger, Afcap Consulting, May 2012. Page 10

- Detailed schedule of activities and sub-activities as well as detailed implementation budget;
- Target locations selected for first round of projects;
- A monitoring and evaluation plan, including final project targets;
- Provisions for environmental impact assessment, mitigation, and monitoring to be undertaken after the inception phase.

The Inception Report will be completed within 60 days of startup.

3.3.2 PROJECT IMPLEMENTATION

SUWASA will structure and manage the project under three specific project objectives:

Specific Objective 1: To support utilities in identifying commercially viable projects and developing bankable financing proposals

SUWASA will provide training and technical assistance to credit worthy utilities to identify, plan, finance and implement commercially viable investments that improve their financial performance and increase the urban poor's access to water and sanitation services. Inputs that will guide this process include the utility strategic plan, utility financial ratios, operating performance indicators, project feasibility studies, cash flow analysis, the business plan and bank financing requirements.

Activities will include:

- Assess challenges to improved financial performance and expanded service delivery to the urban poor;
- Analyze utility financials, Management Information System (MIS) reports, debt service capacity, and profitability;
- Identify commercially viable financing solutions based on market research, financial analysis, cost-benefit analysis and financing terms, among others;
- Develop business plans with utility management and support presentations to the utility board of directors;
- Link the utility with sources of financial, commercial and technical assistance with complementary sector actors;
- Develop infrastructure financing proposals to banks with utility management;
- Monitor outputs to meet debt obligations.

Specific Objective 2. To advise commercial banks in developing water financing products and the lending methodology for utilities

SUWASA will work with bank partners to develop products that serve the water and sanitation utility market and mitigate risks. SUWASA will provide training and technical assistance to bank partners on the regulatory framework, product, financing benchmarks for utilities, risks and mitigants, loan guarantees, etc.

SUWASA activities under this component include:

- Advise on legal framework for lending to utilities;
- Leverage market findings to inform product design;
- Identify and mitigate risk factors of lending to utilities;
- Evaluate financial benchmarks to determine utility credit worthiness;
- Support development of utility loan products;
- Develop water financing tool kit and implement staff training program;
- Support bank monitoring of critical risk factors affecting loan repayment;
- Link banks to financial opportunities that improve security (e.g. DCA), cost of funds (e.g. JICA PSIF) and project incentives (e.g. OBA).

Specific Objective 3. To assess market demand and affordability for water and sanitation services, and support community outreach and education programs related to utility investments

SUWASA will provide support to WSPs in developing and implementing community market assessments and communications materials related to the investment decision. This objective will be guided and informed by a market demand assessment, market research of other development actors, utility MIS reports and customer satisfaction surveys.

SUWASA activities under this component include:

- Conduct market assessment of current water conditions, demand for water, willingness to pay and affordability;
- Identify demand driven and feasible water financing solutions;
- Develop community outreach/education programs;
- Support post implementation follow-up to identify impact.

3.4 EXPECTED RESULTS AND INDICATORS

The results and the indicators for this project are summarized in Table 1 below. These will be refined further during the inception phase.

TABLE 1: RESULTS FRAMEWORK

Goal: To promote innovative reforms and sustainable financing that improve the commercial viability of utility companies and increase access to safe water and adequate sanitation.

Indicators:

- Number of people gaining access to an improved drinking water source (USAID F-indicator).
- Number of people receiving improved service quality from existing improved drinking water sources (USAID F-indicator).
- Number of new policies, laws, agreements, regulations or investment agreements (public or private) implemented that promote access to improved water supply and sanitation (USAID F-indicator).
- Amount of new financing accessed by water and sanitation service providers.
- Number of good practices identified, promoted and adopted.

Objectives	Activities	Expected Results	Indicators
1. To support utilities in identifying commercially viable projects and developing bankable financing proposals	1. Assess challenges to improved and expanded service delivery. 2. Analyze utility financials, Management Information System (MIS), debt service capacity, and profitability. 3. Identify commercially viable financing solutions. 4. Develop business plans with utility management. 5. Link utility with sources of financial, commercial and technical assistance with complementary sector actors. 6. Develop infrastructure financing proposals to banks with utility management. 7. Monitor outputs to meet debt obligations	Project proposals that have sufficient guarantees, future cash flows and high probability of success to be acceptable to institutional lenders for financing. Utilities receive commercial financing for water infrastructure projects.	Amount of new financing accessed by water and sanitation service providers. Number of good practices identified, promoted and adopted.
2. To advise commercial banks in developing water financing products and the lending methodology for utilities	1. Advise on legal framework for lending to utilities. 2. Leverage market assessment findings to inform product design. 3. Identify and mitigate risk factors of lending to utilities. 4. Evaluate financial benchmarks to determine utility credit worthiness. 5. Support development of utility loan products. 6. Support bank monitoring of critical risk factors affecting loan repayment. 7. Link banks to financial	Water financing product(s) developed for the market.	Number of new policies, laws, agreements, regulations or investment agreements (public or private) implemented that promote access to improved water supply and sanitation.

	opportunities that improve security (e.g. DCA), cost of funds (e.g. JICA PSIF) and project incentives (e.g. OBA).		
3. To assess market demand and affordability for water and sanitation services, and support community outreach and education programs related to utility investments	1. Conduct market assessment of current water conditions, demand for water, willingness to pay and affordability. 2. Identify demand driven and feasible water financing solutions. 3. Develop community outreach/education programs. 4. Support post implementation follow-up to determine effectiveness.	Water projects aligned with consumer affordability and willingness to pay. Community understanding and buy-in.	Number of people gaining access to an improved drinking water source. Number of people receiving improved service quality from existing improved drinking water sources.

3.5 PHASED APPROACH

This section breaks the 26-month, $2.4 million[14] project into three phases in order to give USAID the flexibility to invest in the program incrementally as funding becomes available. It shows what can be achieved over time for each phase of the program, as funded in terms of activities, investments and deliverables. The phases include:

- Phase I: June 1 – December 31, 2013 (7 months)
- Phase II: January 1 – December 31, 2014 (12 months)
- Phase III: January 1, 2015 – July 31, 2015 (7 months)

SUWASA Kenya, in collaboration with the water utility, will determine the short-, medium- and long-term investment priorities and decisions, which will guide the work plan and project deliverables. Based on experience and current information, SUWASA Kenya categorized investments according to the time required to identify, plan, finance and implement these projects as explained below:

Short-term projects: There will be up to three rounds of short-term projects over the life of the project (26 months). Extensive market research, technical work and financial analysis is not required for these projects, resulting in a shorter business planning and financial proposal development process. These investments will typically impact the financial performance of the water company. Most of these investments were identified through energy audits conducted by external organizations with 29 urban utilities. Investments include energy efficient motors, pumps, lighting, power factor correction, surge suppressors, load optimizers, and overhead tank installation, among others.

[14] DIG's portion of the total program budget is equivalent to $2,226,862.

Medium-term projects: There will be up to two rounds of medium-term projects over the life of the project. The investments identified by SUWASA and our collaborating partners require some market research, technical work and/or community education and outreach resulting in a slightly longer implementation time frame. These investments will impact the financial performance of the water company and/or improve access to water and quality of service delivery for urban poor consumers. Investments include small scale pipe extensions, pipe rehabilitation, metering, non-revenue water investments (e.g. bulk meters, monitoring equipment), and small pre-paid meter projects, among others.

Long-term projects: There will be one round of long-term projects over the life of the project, which SUWASA Kenya will identify and launch in phase I to give time for completion. The investments require detailed market assessment, financial analysis, risk analysis, technical and budgeting work, and community education and outreach. These investments have a high impact on the financial performance of the water company and/or improve access to water and quality of service delivery for urban poor consumers on a large scale. Investments include household connections and metering, pipe extension/rehabilitation, water treatment and distribution, non-revenue water interventions, pre-paid meter projects, and renewable energy investments in mini hydro, wind energy, and biogas plants, among others.

Project Implementation Phases

Phase I: June 1, 2013 – December 31, 2013

In phase I, SUWASA Kenya will work with up to six utilities on short-, medium- and long-term investments[15]. These six utilities may include current partners KIWASCO and NAWASSCO, whose work SUWASA Kenya will continue to monitor and evaluate as they stabilize operations and consider new investment opportunities.[16] By the end of phase I, SUWASA Kenya will achieve the following deliverables, depending on the six investment types identified:

Deliverables for up to six investment projects in phase I:

- Short-term projects: investments are identified, developed and financed.
- Medium-term projects: investments are identified and a financing proposal is finalized for submission to the bank.
- Long-term projects: investments are identified and market research and/or technical drawings and budgets are developed.

Phase II: January 1, 2014 – December 31, 2014

In phase II, SUWASA Kenya will identify and launch new short-term and medium-term projects and will continue work on existing short-, medium- and long-term projects. While preparations will have started in phase I for these medium- and long-term projects, the bulk of the work will take place in phase II and phase III.

Deliverables for up to eight investment projects in phase II include:

[15] Note that activities with utilities may be staggered once project implementation begins.
[16] Both companies have expressed their desire to partner in the new project. NAWASSCO is considering scaling up the pre-paid meters and energy saving investments. KIWASCO will require time to stabilize operations after the large scale household connections project but is considering another household connections project and energy saving investments.

- Short-term projects:
  - New: investments are identified, developed and financed.
  - Existing: monitoring and evaluation of financial impact on the WSP and lessons learned.
- Medium-term projects:
  - New: investments are identified, developed and financed.
  - Existing: financing proposals are approved by the board, submitted to the bank and financed. Materials are tendered and procured, and implementation (project roll-out, infrastructure laid, connections made, improved access to water delivered) is completed. Monitoring and evaluation activities begin.
- Long term projects:
  - Existing: investments are financed and implementation begins. Significant emphasis is placed on community education and outreach.

Phase III: January 1, 2015 – July 31, 2015

In phase III, SUWASA Kenya will manage existing short-, medium- and long-term projects. Phase III will focus primarily on project implementation (project roll-out, infrastructure laid, connections made, improved access to water delivered) and community education and outreach activities. Monitoring and evaluation and documentation of impacts will be on-going throughout this phase.

Deliverables for eight or more investment projects in phase III include:

- Short-term projects:
  - Existing: Financing proposal approved by board and submitted to the bank. Implementation and monitoring and evaluation of financial impact on the WSP and lessons learned.
- Medium-term projects:
  - Existing: Materials are tendered and procured, and implementation (project roll-out, infrastructure laid, connections made, improved access to water delivered) begins. Community education and outreach activities are on-going and monitoring and evaluation of lessons learned and outcomes is underway.
- Long-term projects:
  - Existing: investments are implemented and support is given to community education and monitoring, evaluation and lessons learned. The project implementation includes rolling-out the product or service, laying/installing infrastructure, making water connections to households and/or infrastructure, and helping people access improved water services.

3.6 ASSUMPTIONS AND RISKS

3.5.1 ASSUMPTIONS

The SUWASA Kenya Innovative Utility Finance project proposes to develop and implement water financing products in a relatively new market. The target market, in this case WSPs, is distinct from traditional borrowers as they provide a public good and have additional regulations placed on them. While no destabilizing changes are expected under the transition to the new Kenya constitution, this fluid regulatory environment is also a factor to consider. In this context, the key assumptions for the project are a relatively stable economic environment and regulatory environment that are conducive to financing and that reduce risks associated with the introduction of new financing products.

3.5.2 RISKS

SUWASA assessed the key risks to achieving success in this project. While the risks are considered low and manageable, SUWASA will review contingencies in detail during the project and will consider additional risk mitigation measures, if required:

- *Regulatory Risks.* The MWI Annual Water Sector Review 2011-2012 draft report includes a discussion of the plan to adapt the sector reforms to the new constitution, noting that:

  > Kenya's new constitution recognizes water and sanitation as a human right and underscores the Government's commitment to ensuring sustainable access to safe, reliable and affordable water supply and sanitation services. The MWI has prepared Water policies (Water Resources Management Policy, Water Supply and Sanitation Policy and Irrigation and Water Storage Policy) and a Water Bill 2012 in line with the new constitution which have been submitted to the Constitution Implementation Committee (CIC). The policies and the Water Bill integrate lessons learned from the reform process with its successes and failures to ensure that the gains achieved from the water sector reforms are not lost in the transition to a devolved government.

  The risks associated with the transition are that there will not be sufficient clarity to WSPs and the new county governments and that this will lead to confusion and paralysis in relation to decision making on larger, innovative projects that involve financing. It is important to note, however, that a senior MWI official who presented the Transition Plan to the Water Services Technical Group in November 2012 stressed the clear intention to maintain the current sector guidelines related to regulations, tariffs, environmental compliance, water quality compliance, etc. and to minimize the impact at the WSP level to ensure no disruption of services.

- *Financial Risks.* The financial risks for the project are macroeconomic in nature. Inflation and currency fluctuations and interest rates charged by banks impact the implementation costs of projects, project feasibility and business planning. This was the case in 2011, when inflation was near 20% and the Central Bank rate reached a high of 18%. In 2012, Kenya returned to a relatively stable economic environment with inflation now below 4% and the Central Bank rate currently at 9.5%.

- *Political Risk.* On March 4, 2013, Kenya held general elections and began the transition to a devolved government system. The political environment is very sensitive. For WSPs, this means that they will now report to newly-created Governors (as opposed to the Municipal

Council). In the short-term, this may create some uncertainties as Governors familiarize themselves with the sector; however, the regulatory board for the sector is clear in wanting to maintain no disruptions to services and ensuring that the gains of the 2002 Water Act continue.

- *Institutional Risks*. As with any financial product, there are factors that may affect the financial institution's priorities and decisions. There are external factors including macroeconomic fluctuations, market demand, and regulatory changes, as well as internal factors including strategy, product line decisions, liquidity, risk thresholds, etc. Given the stability of the bank partners, especially KCB, and the fact that KCB and K-Rep Bank have signed USAID DCA agreements (protecting the bank in case of default by the WSPs), this risk is considered low.

- *Capacity-related Risks.* The risks associated with capacity lie primarily with the water service providers and include implementation risks associated with misdirection or inefficient use of loan funds, poor project management skills leading to delays, and a general lack of communication between departments and staff that can lead to a lack of coordination of tasks. The experience of SUWASA Kenya in implementing two projects with partners provided many lessons learned on how to manage project planning to minimize these risks.

3.7 LINKAGE WITH OTHER USAID OPERATIONS

USAID/Kenya

SUWASA Kenya is in regular communication with the USAID/Kenya Water, Sanitation & Hygiene (WASH) Specialist (and others) to provide updates on the current project and share and receive information about current sector issues and events. USAID Kenya has supported the project in discussions with USAID DCA and in introducing SUWASA Kenya to key sector leaders. In October 2012, the SUWASA Chief of Party and Deputy Chief of Party and the SUWASA Kenya Team Leader presented at a USAID/Kenya WASH strategic planning session in Nairobi. The session was facilitated by the USAID Bureau for Africa team. The Agriculture, Business and Environment Office has finalized the new WASH strategy, and SUWASA will work closely with the Mission to determine areas for collaboration. The local Mission is also considering a buy-in to support the SUWASA Kenya project.

USAID Development Credit Authority

A USAID Development Credit Authority (DCA) guarantee is in place or in process with the two bank partners, KCB (signed) and Housing Finance (by September 30, 2013), for the proposed project. The guarantee is designed to strengthen the bank's ability to finance loans to non-sovereign enterprises in the water sector in Kenya. The subsidy cost of the transaction is co-funded by USAID and the Department for International Development (DFID) through its relationship with Gatsby Charitable Trust. In a meeting in October, SUWASA, USAID Kenya Agriculture, Business and Environment Office, and the USAID Office of Development Credit voiced strong support for the new project. This was based on a strong desire for the effective utilization of the DCA guarantees with KCB and Housing Finance.

USAID Bureau for Africa

The USAID Bureau for Africa vision statement includes an objective "to improve urban infrastructure and service delivery for secure access to potable water, sanitation and energy." Related to the SUWASA Kenya work and the new project, the Bureau for Africa has played a significant role in two key aspects. The first is the role of the Bureau in working with the local USAID Kenya Mission on the new WASH strategy as mentioned in the USAID Kenya section above. The second is the Bureau's position as the designated contact under the Statement of Intent (SOI) between USAID and Japan International Cooperation Agency (JICA) on Coordination to Support Water Development in Africa. SUWASA shared the general parameters of the SUWASA Kenya project outlined in this work plan with the USAID Bureau for Africa in October to inform on-going discussions between USAID and JICA to identify projects and financing opportunities under JICA's Private Sector Investment Finance credit support program.[17]

3.8 COMPLEMENTARITY WITH OTHER DEVELOPMENT PARTNERS

World Bank – WSP

The World Bank-WSP has been a major sector informant in analyzing progress under the water sector reforms and promoting sustainable and commercially viable investments in the water and sanitation sector. The World Bank–WSP has also provided an output based aid component through K-Rep Bank to promote financing of small piped water systems and household connections in rural and peri-urban Kenya. The World Bank-WSP's support to WASREB on the urban WSP shadow credit rating exercise will serve as a guide on the selection of WSPs under this project. During this exercise, <u>World Bank-WSP identified USD 18.4 million in WSP investments for rehabilitation, pipe extensions, treatment plants, household connections and non-revenue water reduction</u>. SUWASA Kenya will work closely with World Bank-WSP to determine which projects are suitable for SUWASA Kenya technical assistance. Some projects will also be eligible for World Bank-WSP Output Based Aid (e.g. household connections projects).

Vitens Evides International (VEI) / Netherlands Development Organization (SNV)

The EU-funded Partnerships for Capacity Building and Sustainable Development and Maintenance of Water Infrastructure in Kenya program was launched in March 2012. The four-year program aims to increase water and sanitation coverage and improve efficiency in service delivery. Program funding is channeled through Vitens Evides International (VEI), while the implementing partner is the Netherlands Regional Water Authority. SNV and the Sustainable Aid in Africa International (SANA), a local NGO, are supporting partners. SNV has established a pro-poor unit within two water service providers (Nakuru, Kisumu). SNV is also <u>documenting and incorporating best practices in non-revenue water reduction, developing and implementing a trainer of trainers program in non-revenue reduction, and will be scaling up the non-revenue water reduction model to 17 peer water service providers</u>, as well as monitoring and evaluating implementation.

VEI has made significant steps in identifying "smart investments" for WSPs to reduce non-revenue water. The VEI Project Manager has data on these interventions and would like to collaborate with SUWASA Kenya to support the financing proposal development process.

Strengthening Water Associations Partnership (SWAP-bfz)

[17] This project's focus on energy-related investments also supports the Bureau's vision. There is also an emerging interest in the sector for Public-Private Partnerships that could support the USAID-JICA SOI.

In a partnership between bfz and two associations in the water sector, Water Supply Providers Association and the Kenya Water Industry Association, energy audits were conducted with water service providers with a view to identify measures to save energy and increase the use of renewable energy. Energy auditors contracted by the Kenya Association of Manufacturers conducted 29 WSP audits and produced reports detailing energy saving measures and in some cases renewable energy projects.

The audits identified energy saving measures worth KES 110,220,511 (USD 1,296,712) in savings *per year* to companies which will be realized by investing 130,425,302 (USD 1,534,415) in energy saving projects. The overall payback period for these measures is 1.18 years. The most energy will be saved by right sizing of pumps, use of energy efficient motors, energy management systems, piping improvements and replacement of faulty pumps. Renewable energy projects identified included solar lighting, solar pumping, small hydro, biogas plants and the use of turbine pumps. Renewable energy projects require KES 1,264,271,600 (USD 14,873,784) in investments with an annual income of KES 314,203,747 (USD 3,696,515) giving a simple payback period of 4.02 years. However, these measures need further analysis to better assess the business planning and other factors over the longer payback period. SWAP-bfz is interested in collaborating with SUWASA Kenya to support the project with the financing component and will visit WSPs with SUWASA Kenya during the WSP project selection process.

Development Alternatives International (DAI)

DAI helped to build the USAID Kenya Development Credit Authority guarantee program in Kenya. Through the Financial Inclusion for Rural Microenterprises (FIRM) project, DAI works to expand and develop new financial services in five areas key to Kenyans' economic well-being: agriculture, renewable and clean energy, information and communication technology, gender and youth, and policy reform. In October 2012, DAI signed a new DCA guarantee with Kenya Commercial Bank to support water financing, and is developing a DCA guarantee with Housing Finance. Both bank guarantees cover the full period of this project.

Government of Kenya Water Services Trust Fund (WSTF)

Water Services Trust Fund, Kenya is a State Corporation established under the 2002 Water Act, with the mandate "to assist in financing the provision of water services to areas of Kenya which are without adequate water services." WSTF initiated an urban program, consisting of the Urban Projects Concept (UPC), Ecosan program and Majidata pro-poor program, aimed at funding water and sanitation in the low income urban areas. Funded by KfW, European Union and GIZ, the UPC program (and its funding partners) are supporting an Aid-on Delivery (AoD) program for utilities that use commercial financing for investments that increase access to water and sanitation. AoD functions similarly to output-based aid, making payments of up to 50% of the total financing amount as partners achieve milestone. SUWASA Kenya will explore collaborations with WSTF and submit projects to WSTF to determine if they qualify for AoD.

3.9 PROJECT PARTNERS' CONTRIBUTIONS

Project and collaborating partner contributions will be essential to SUWASA in achieving expected project results. Specific contributions of partners will be agreed upon during the inception period. Expected contributions are summarized below.

TABLE 2: CORE AND COLLABORATING PARTNER CONTRIBUTIONS

Core and Collaborating Partner Contributions	
Core Partners	
Partner	**Contribution**
SUWASA	Funding for staff, travel, transportation, and activities Business planning and financial proposal development with utility partners. Financial product development with bank partners and training to staff. Global forum for promotion of the project and achievements. Platform for moving achievements toward scale across Kenya and Africa.
Kenya Commercial Bank (KCB) and Housing Finance	In-kind provision of staff time, office facilities and systems. Analysis of utility financing applications and application of due diligence criteria. Financing of project and loan management.
Utility companies	In-kind provision of staff time, office facilities and systems. In-kind leadership in all aspects of project identification, financing and implementation.
Collaborating Partners	
Partner	**Contribution**
World Bank – WSP	Shadow credit rating of 43 urban utilities to assess credit worthiness (completed). Independent funding for identification of water and sanitation financing projects. Output based aid incentive in the case of household connections projects.
VEI / SNV (EU funded)	Independent funding for implementation of non-revenue water reduction project identification. Staff and office space: Collaboration with SUWASA in identifying priorities and groupings of projects to maximize impact. Independent funding to support a Pro-poor Coordinator at selected utility companies for project support and monitoring.
SWAP-bfz (EU funded)	Independent funding for implementation of Energy Audits with urban utilities (completed). Staff and office space: Collaboration with SUWASA in identifying priorities and groupings of projects to maximize impact.
USAID DCA (partner– Development Alternatives International – DAI)	Guarantee to bank partners KCB and K-Rep Bank to support bank financed utility infrastructure projects.
GoK Water Services Trust Fund	Technical review of projects Aid on Delivery for qualifying projects

3.10 INSTITUTIONAL ARRANGEMENTS AND PERSONNEL PLAN

3.9.1 INSTITUTIONAL ARRANGEMENTS

During the inception period, SUWASA will establish agreements, primary contacts and a general framework with bank and utility leadership to identify, plan and implement the project.

The following table summarizes the respective roles and responsibilities of SUWASA and the utility and bank partners.

TABLE 3: PROPOSED CORE PARTNER ROLES AND RESPONSIBILITIES

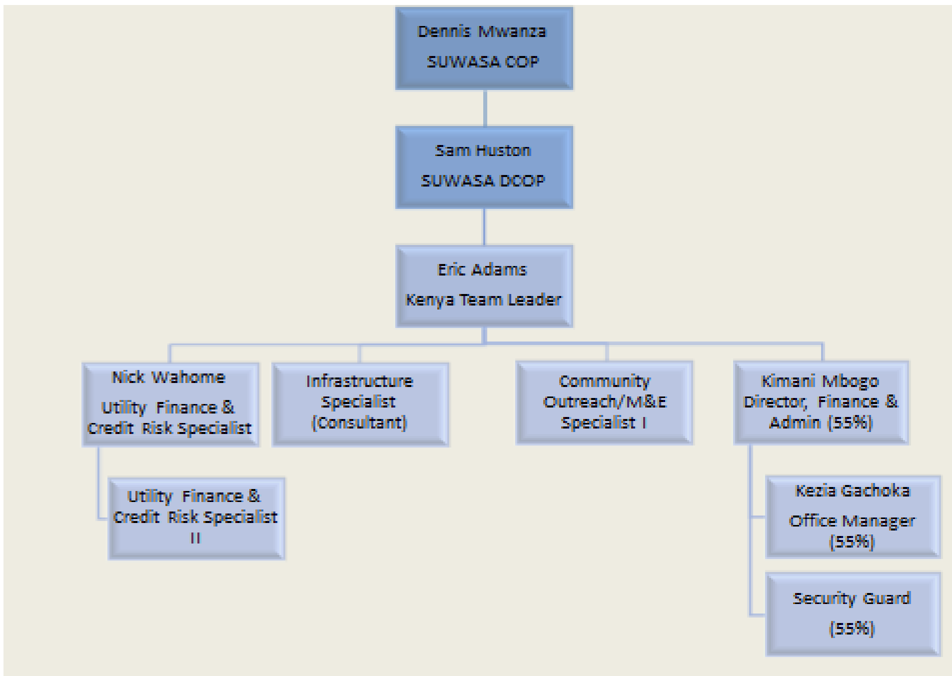
Proposed Core Partner Roles and Responsibilities		
SUWASA	**Utility**	**KCB and Housing Finance**
Project Management		
Provide all office equipment needed by staff in Nairobi. Cover staff costs for travel and per diem		
Provide transportation and associated fuel costs for staff in Nairobi.	Oversee all field activities related to implementation.	
Provide salary, benefits, and legal costs for staff.		
Coordinate all activities with partners.		
Provide technical direction to staff in Nairobi.		
Ensure accountability of staff performance.		
Prepare Scopes of Work and mobilize technical assistance as needed.		
Specific Objective 1: To support utilities to identify commercially viable projects and develop bankable financing proposals		
Assess challenges to improved and expanded service delivery	Participate and inform discussions on priority investments	
Analyze utility financials, Management Information System (MIS), debt service capacity, and profitability	Keep stakeholders informed of investment planning process, decisions, and implementation	
Identify commercially viable financing solutions	Provide staff and resources to support market assessment, business planning and financial proposal development	
Develop business plans with utility management	Provide financial contributions toward the investment (typically 20-25% required by the bank)	
Develop infrastructure financing proposals to banks with utility management	Comply with bank requirements for financing	
Monitor outputs to meet debt obligations	Procure goods and services required for the investment	

	Identify a key contact and project leader to oversee and implement investment project	
	Support communications and report monthly on project implementation	Participate in the project launch ceremonies
	Work with SUWASA on public communications to the media	Work with SUWASA on public communications to the media
Specific Objective 2: To support commercial banks in developing a water financing product and methodology for utilities		
Advise on legal framework for lending to utilities		Provide bank's product program methodology framework and jointly develop with SUWASA
Leverage market findings to inform product design		Provide forum for staff training and communications materials to educate bank personnel on the product
Identify and mitigate risk factors of lending to utilities		Branch officers will engage directly with the WSP to ensure smooth application, due diligence and approval process
Evaluate financial benchmarks to determine utility credit worthiness		Project loan application review, approval, disbursement and follow-up
Support development of utility loan products		
Develop water financing tool kit and implement staff training program		
Support bank monitoring of critical risk factors affecting loan repayment		
Specific Objective 3: To assess market demand and affordability for water and sanitation services, and support community outreach and education programs related to utility investments		
Conduct market assessment of current water conditions, demand for water, willingness to pay and affordability.	Provide field staff to support and guide market assessment work, provide staff to be trained to conduct the market assessment	
Identify demand driven and feasible water financing solutions	Review market surveys and focus group discussion questions, translating and adapting colloquialisms as needed	
Develop community outreach/education programs	Introduce surveyors, SUWASA staff and visitors to local leaders and chiefs	
Support post implementation follow-up to identify impact	Help develop and implement community education and outreach materials, provide staff to deliver materials	

3.9.2 PERSONNEL AND MANAGEMENT PLAN

The SUWASA implementation team is expected to include a Team Leader, Utility Finance & Credit Risk Specialist, Infrastructure Specialist, Community Outreach/M&E Specialist, and Director of Finance and Administration based in Nairobi.

FIGURE 2: ORGANIZATIONAL CHART



Key program staff in-country

Team Leader, Eric Adams

The Team Leader reports to the SUWASA DCOP on all key activities. As a senior member of DIG's programs team, DIG's Director of Global Programs also serves as the Team Leader's supervisor. The Project Team Leader will work closely with the DCOP and SUWASA team in the start-up and implementation of the project. He will also work closely with all key stakeholders – core partners and collaborating partners - to broker partnerships and unlock financial innovations.

Utility Finance and Credit Risk Specialist (Nick Wahome and 1 person TBD)

The Utility Finance and Credit Risk Specialist reports directly to the Team Leader and will support the utility credit worthiness and debt capacity analysis, market assessment process, financial inputs/outputs to the business plan and financing proposal, facilitate communication and follow up with partners, report on progress and issues, and provide advice and training to bank partners on product methodology and training of staff.

Infrastructure Specialist (Consultants TBD)

The Infrastructure Specialist reports directly to the Project Team Leader and will provide specific technical assistance and support directly to utility partners to inform and assess the project's commercial viability, bill of quantities, design, financing requirements and implementation timeline. Consultants with specialized expertise for distinct projects will be hired.

Community Outreach/M&E Specialist (TBD)

The Community Outreach/M&E Specialist reports directly to the Project Team Leader and will provide project specific support to utility partners with community education and outreach activities. This person will also support M&E activities including focus group discussions, before and after studies and documentation of success stories and snap shots.

Key program STTA staff

DIG Director of Global Program Management, Tara Panek Bringle

The Director of Global Program Management provides overall financial and programmatic oversight, as well as quality control for the project and its deliverables. She ensures compliance with the Tetra Tech contract and USAID regulations, and is the direct liaison with the Tetra Tech home office team on contractual and compliance matters. Furthermore, the Director of Global Program Management provides technical guidance, support, and oversight to the field team, as well as technical assistance on strategic and business planning, market assessments, financial and institutional analysis, financing proposals, and monitoring and evaluation.

DIG Program Officer, Ammayle Kasi

The Program Officer is the primary programmatic and administrative backstopping support for the project. She contributes to writing, editing, and assembling project deliverables and reports and monitors budget expenditures. She also ensures contracts are in compliance with the Tetra Tech contract, USAID regulations, and project timelines and deliverables. Furthermore, the Program Officer provides technical assistance on market assessments, communications, community outreach, knowledge management, and monitoring and evaluation.

DIG Director of Global Microfinance Consulting Services, Ruby AlSalem (STTA)

In coordination with the Project Team Leader, the DIG Director of Global Microfinance Consulting Services will provide short-term TA to support and facilitate all aspects of the market assessment including survey design, training and management of enumerators, data collection, quality control, and analysis and recommendations. Ms. Salem will also provide short-term TA to support bank partners including water financing training tools design and tailored capacity building programs. Training will address integration of new water and sanitation financing including loan application, due diligence procedures, risk assessment, and analysis of product(s) performance.

Additional STTA

In addition to the specific STTA activities noted above, the DIG project management team for SUWASA (based at DIG US) will provide short-term support in the area of financial innovations and services, as needed.

MONITORING, EVALUATION AND REPORTING ARRANGEMENTS

3.11 INTERNAL MONITORING AND QUALITY CONTROL

The SUWASA Chief of Party (COP) has ultimate responsibility for ensuring the quality of performance and deliverables. The project Team Leader, with support from the SUWASA Regional Office, will be responsible for the day-to-day monitoring of the project implementation process and reporting progress. Regular reviews on the project progress will be carried out either through teleconferences or weekly updates to the SUWASA COP. Additionally, monthly and quarterly progress reports will be prepared by the Team Leader highlighting the key project accomplishments, challenges and lessons learned. These reports will be used to generate the periodic reports submitted to USAID as part of the contractual reporting requirements for SUWASA.

Periodic project visits to review the progress in project implementation will be undertaken from the Regional Office and Tetra Tech ARD Home Office as one of the mechanisms for internal monitoring and quality control. Internal data quality assessments will also be conducted periodically to ensure data quality.

3.12 MONITORING AND EVALUATION PLAN

Based upon the initially proposed activities, results and indicators, the Team Leader, with assistance from the SUWASA Regional Office in Nairobi, will prepare a Performance Monitoring Plan (PMP) as part of the Inception Report prepared during the first 60 days of the project. The PMP will specify expected SUWASA results, outputs, outcomes and impact; indicators for measuring results; proposed targets; and monitoring periods and documentation required for performance audits and evaluations.

3.13 ENVIRONMENTAL COMPLIANCE MONITORING

Since the project will facilitate investments, SUWASA will ensure compliance with USAID environmental requirements (22 CFR 216). SUWASA will identify specific actions that are required to ensure that activities comply with the Environmental Threshold Determination in the SUWASA Initial Environmental Examination. SUWASA will prepare an Environmental Review Report that:

- Identifies and characterizes the significance of all environmental and social impacts of investments;
- Recommends whether or not an Environmental Assessment (EA) is required and, if an EA is required, provides a Scope of Work;
- Includes an Environmental Mitigation and Monitoring Plan, identifying all measures required to assure compliance with 22 CFR 216; and
- Adheres to the GoK environmental laws, decrees and obligations, as provided by the Ministry of Environment.

3.14 REPORTING ARRANGEMENTS

The Team Leader will provide project management reports as follows:

- Inception Report, including an updated Overall Work Plan and Final Monitoring and Evaluation Plan, due 60 days after project start up;
- Monthly Reports, including a narrative on the reporting period, discussing actual project progress vis-à-vis planned and agreed project schedules, and an updated schedule of activities Quarterly Report detailing key accomplishments, lessons learned and challenges, planned activities for the next quarter, and a financial report;
- Final Report, including all activities performed, results achieved and resources used. The Final Report will also include a thorough analysis of established performance indicators.

4. RESOURCE TABLE/BUDGET

The total expected budget of $2.4 million includes subcontracting DIG. DIG will in turn have a full-time Team Leader based in Nairobi for the life of the project, supported by a complement of long-term and short-term staff and consultants, and will incur field and headquarters office expenses, travel, and headquarters' staff costs (management and support) in implementing the project.

The detailed budget comes as a separate document.

5. PROJECT IMPLEMENTATION PLAN

The implementation plan shows the coordination of activities with utility and bank partners and the integration of community market research findings and outreach initiatives. The start date is June 1, 2013. SUWASA Kenya will focus on project proposal development in three phases.

TABLE 4: PROJECT IMPLEMENTATION PLAN

U.S. Agency for International Development
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