

# Scaling Up Blended Financing for Water and Sanitation in Kenya

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## Summary Overview

**Location:** Kenya, Sub-Saharan Africa

**Approach to Blended Finance:** Over the last decade, Kenya has experimented with different ways of using blended finance to leverage commercial financing from domestic banks. Many such efforts have focused on using Output-Based Aid (OBA) subsidies to bridge the financing gap that water service providers face when serving poor customers. Such programs were first developed for community-based water schemes, in which the OBA subsidies were awarded based on results to reduce loan repayments. These have been scaled up for utilities at the national level through the Kenya OBA fund. Nairobi Water Supply Company has established similar arrangements to expand water and sewerage services in poor areas. These initiatives have been supported over time through considerable efforts to improve sector transparency through the preparation of water utilities' credit ratings funded by donors and later through a utility creditworthiness index led by the water service regulator.

## Context

The Kenya Vision 2030 national development plan, in line with the water Sustainable Development Goal (SDG 6), seeks universal access to safe water and sanitation for all by 2030. The annual costs of investment and rehabilitation for water supply is estimated at US\$303 million. However, it is estimated that existing sources of financing can only provide approximately US\$193 million per year, underscoring the deep financing gap (World Bank 2016). Domestic commercial lending to water utilities has the potential to help bridge this gap, although experience in this area is still limited in Kenya.



The Kenya Water Act of 2002 introduced important reforms in the sector, separating responsibilities for asset ownership and operation, creating autonomous utilities and an independent sector regulator, ring-fencing revenues within the sector, and establishing a framework for utilities and other county-owned Water Service Providers (WSPs) to move toward cost-reflective tariffs. At present, communities operate many small piped-water systems in rural and peri-urban areas. WSPs serve approximately 51 percent of the population in their service areas and 23 percent of the total population. These utilities lack familiarity with commercial banks' lending practices and are not familiar with the steps that are required in order to become creditworthy. They typically are limited by their inability to provide sufficient collateral to secure loans, and lack adequate self-financing.

High commercial interest rates pose an additional barrier. Local banks perceive the sector as financially weak, and

have been hesitant to lend without assurance through risk mitigation support. Concessional finance and credit enhancements can help to strategically lower borrowing costs, and facilitate the development of commercial finance options for the sector.

## Approaches to Blended Finance and Results

Over the last ten years, Kenya has experimented with various approaches to using blended finance in order to help mobilize commercial finance. Efforts have so far been focused on using output-based subsidies (i.e. performance-based incentives paid to service providers to enhance access to infrastructure services for the poor) and on increasing transparency in the sector through the development of creditworthiness indices. These initiatives are paving the way for more comprehensive and currently ongoing approaches to mobilize commercial financing into the water sector. The following presents some of these initiatives and results observed on the ground.

### Output-Based Aid (OBA) and Maji ni Maisha

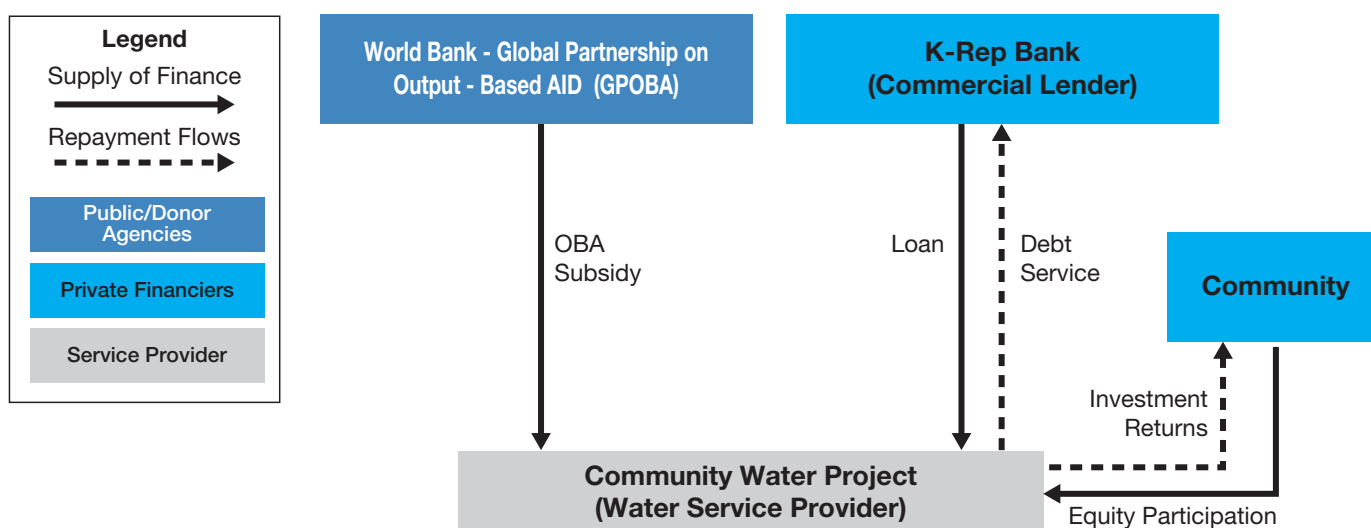
One of the first attempts at using blended finance to mobilize commercial financing in the country is the Maji ni Maisha program. The World Bank launched the pilot loan program in 2007 with K-Rep Bank, a Kenyan commercial bank specializing in microfinance lending. The objective

was to incentivize rural and peri-urban communities to access loan financing so as to rehabilitate and expand small-piped water systems. The program identified projects requiring up to US\$200,000 for investment to cover O&M costs, which had the potential to repay their loans.

Qualifying communities contributed 20 percent of project costs in pre-financing and K-Rep Bank financed 80 percent through a medium- to long-term loan. Once an independent review confirmed that the community project had met its pre-agreed targets, the output-based grant (OBA) of up to 40 percent of total eligible project costs was transferred to the community, reducing the debt service costs and enabling the supply of water at affordable rates. The subsidy was used to refinance the loan, and communities repaid the remaining amount over five years through operating revenues from water sales. To mitigate the risk of implementation failure, K-Rep Bank purchased a partial credit guarantee from USAID's Development Credit Authority for 50 percent of K-Rep's exposure. Figure 1 shows the financial structure for the Maji ni Maisha program.

The program was later scaled up with support from the European Union. By 2012, some 35 communities had borrowed US\$3.4 million from K-Rep Bank, raised US\$1.2 million of equity, and accessed OBA grants of US\$2.8 million. This enabled provision of access to 190,000 people.

**FIGURE 1** Scaling Up Blended Financing for Water and Sanitation in Kenya: Maji ni Maisha Financial Structure



### Output-Based Aid (OBA) and the Nairobi City Water and Sewerage Company (NCWSC)

Another initiative is under implementation by Nairobi City Water and Sewerage Company (NCWSC) to leverage an OBA grant to attract commercial financing in order to connect 16,000 households to the water and sewerage networks. NCWSC is negotiating a commercial loan to finance the project: an OBA grant is expected to reimburse NCWSC for up to 70 percent of the costs of the sewerage connections and compound toilets, and up to 40 percent of water connection costs, upon verification that the agreed outputs have been met. It is expected that the loan will be provided in local currency for a tenor of ten years. The loan will likely not require a guarantee, thanks to the strong balance sheet maintained by NCWSC.

### The Kenya OBA Fund

At national scale, the Kenya OBA Fund is supporting the Water Services Trust Fund of Kenya to run a results-based financing program that provides grants to WSPs that access commercial loans from domestic lenders for investment projects. The loans are intended to back investments that deliver household water and sewerage connections, public water kiosks, and public toilets, while targeting the grant qualification to low income areas. The OBA grant will be used to buy down 60 percent of the subproject cost financed by domestic lenders. The program is supported by the World Bank through the Kenya Output-Based Aid (OBA) Fund for low-income areas and by KfW, through the Aid on Delivery (AOD) program.

### Improving Transparency for Investment Via a Creditworthiness Index

Demonstrating creditworthiness is an important way to attract commercial finance, so as to inform lenders and help them overcome their lack of familiarity with the sector. To that end, the Water Services Regulatory Board (WASREB) worked with the World Bank to develop a mechanism to assess utility creditworthiness in Kenya. The result was the production of 43 utility shadow credit ratings, to help inform investors' decisions and their perception of the risk of investing in Kenyan water utilities. The ratings also provided utilities with a diagnostic tool to help them identify problem areas. Based on these early efforts, WASREB is in the process of developing a creditworthiness index to assess the credit risk of WSPs on an annual basis, with a view to improve transparency and attract commercial financing into the sector.

## Lessons Learned

**A conducive operating environment and legal framework proved important to attract bank lending in Kenya.** The 2002 Water Act shaped the environment, and opened up opportunities to access finance. In particular, the Act established providers as autonomous entities, ring-fenced revenues within the sector (directing income from water sales to O&M and capital expenses), and created the role of an independent regulator.

**Sector reforms and fostering the interest of commercial banks go hand in hand.** Both types of activities require time and call for developing a sufficient pipeline of bankable projects. In Kenya, despite sustained efforts over the last 10 or 15 years, no “quick win” solution has emerged at scale as of yet.

**Credit enhancement instruments can mitigate lender risk, and improve financial viability.** This in turn can enhance security of a transaction and incentivize lenders to kick-start the flow of commercial finance. In Kenya, the use of partial credit guarantees and OBA grants were essential in accessing commercial investments.

**Technical assistance is key for assessing the financial viability and feasibility of investment projects, improving the bankability of utilities, and supervising project implementation, reassuring lenders of their investment choices.** Technical assistance has been instrumental in overcoming capacity and knowledge constraints during the nascent phase of commercial finance developments for the water and sanitation sector in Kenya.

**Commercial debt can bring governance benefits to WSPs.** This can take the form of added oversight from lenders, and help providers improve capital expenditure planning, operating efficiency, and financial management.

**Sufficient revenue generation, backed by a broad customer base willing to pay for water services, is critically important.** Ultimately, projects that can attract commercial financing should generate their own revenue, such as investments in network expansion, metering or improving energy efficiency.

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This case study is part of a series prepared by the World Bank's Water Global Practice to highlight existing blended finance experiences in the water sector.

Blended finance refers to "the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets," as per the OECD definition (WEF OECD, 2015). Concessional funds can be used in a catalytic manner to open up new opportunities for commercial financing, by providing technical assistance to borrowers and lenders to help them become more familiar with each other, help structure transactions, provide credit enhancement mechanisms, etc.

Private capital flows can help with meeting immediate financing needs for investment in the water sector but ultimately need to be repaid. Repayable financing from private sources to the water sector can come in various forms, including as commercial bank loans, bonds or equity. To obtain such financing, water-sector actors need to be able to repay the borrowed amounts and the associated funding costs, which means that they need to be deemed "creditworthy" by providers of finance.

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