

Sector Finance and Resource Flows for Water Supply

A Pilot Application for Kenya

Executive summary

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Background, Objectives and Approach

Regional Study of WSS Resource Flows. The Sub-Saharan African Region (SSA) has a high proportion of countries with the lowest incomes in the world and high levels of poverty. In this context, inadequate financial resources and inappropriate financing mechanisms are often cited as constraints to scaling up sector reforms. However, the lack of comprehensive understanding of the existing flows of financial resources often makes it difficult to assess their links with sector reforms. This understanding is particularly relevant in the context of Millennium Development Goals (MDGs) and is also identified as one of the key reasons for the weak representation of the water and sanitation sector in the preparation of the poverty reduction strategy papers (PRSPs) and the linked budget process through the medium term expenditure framework (MTEF). It is in this context that the regional study aims to: a) develop a framework to assess the WSS related financial resource flows, and b) develop a benchmarking tool to assess the sector financial performance. The main outcomes of the regional work are to develop a better understanding of the water sector finance for its improved integration with the PRSP and MTEF and contribute to the development of a country-level financing strategy. The central premise of this study is that these outcomes are essential to develop more meaningful country level action plans for achievement of the MDGs.

Studies have been initiated in three countries in the region for resource flows assessment using the tools of institutional and financial mapping, and public finance analysis. The preliminary analysis was based largely on available studies and information. Detailed studies will be taken up later as appropriate. Findings of the country studies will also feed into the benchmarking exercise.

Study Objectives and Approach in Kenya. Kenya was selected for pilot application of resource flows assessment. In developing the framework for Kenya, the assessment is also positioned in the context of recently initiated WSS sector reforms. The objectives of the study in Kenya are:

- To develop and test a framework for measuring resource flows and public finance – including:
 - mapping the existing and emerging institutional arrangements and preliminary estimation of expenditures by all key service providers;
 - mapping the existing and emerging financing arrangements and assessing the relative contribution of funds by different channels and sources of finance; and

- analysis of public finance: a) a review of allocation and expenditure at national and local levels, and b) the financing rules and mechanisms that influence public institutions and sector finance
- To review the implications of the study findings in the context of sector reforms in Kenya and identify the next steps for a sector financing strategy for the water sector in Kenya; and
- To contribute to the development of guidelines for country studies and benchmarking the performance of WSS sector finance as a part of the regional study.

The study is based on available information from a number of sources: government budget documents, actual expenditure from the sector ministry and other institutions, for local authorities from the database on Local Authority Transfer Fund (LATF) and information on small private providers in Nairobi from the Nairobi City Council. The information on NGOs is obtained from the NGO Bureau, NGO Council and consultations with selected NGOs. Other information on the community schemes and small providers is based mainly on secondary sources of information available from earlier studies. A few words are needed on the limitations of information for this first phase of the study. In some cases, such as for the non-governmental sector, community schemes, and small private providers, it has been necessary to use the limited available information with 'best judgment' assumptions to arrive at national estimates. Finally, though it was intended to include sanitation and household/community expenditures (other than for user charges) in the study, this has not been possible due to the lack of adequate information at this stage.

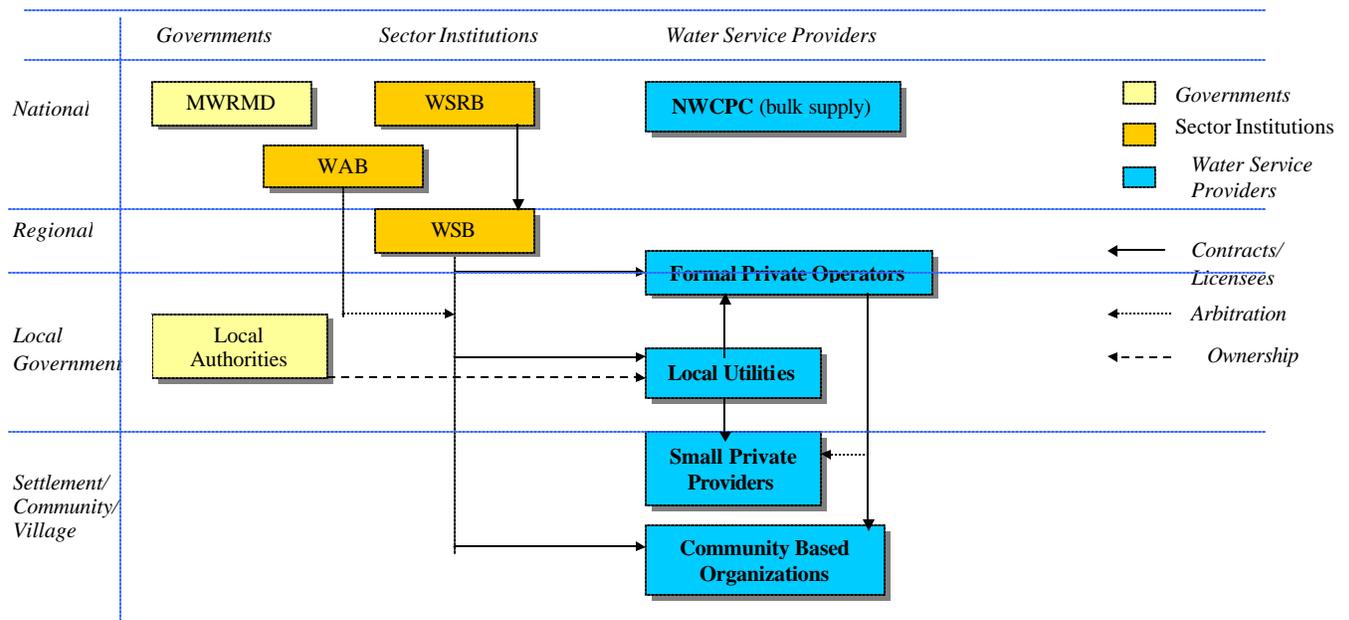
Key Study Findings

Institutional Mapping – Service Providers in Kenya

Several different water service providers operate within the existing institutional arrangements in Kenya (refer Figure 1), including the public sector providers as well as community-based and private small service providers (PSSPs). Almost 50 percent of the total 'served' population is within the ambit of two national providers: the water supply department (WSD) of the Ministry for Water Resource Management and Development (MWRMD), and the National Water Conservation and Pipeline Corporation (NWCPC). These national entities serve both the urban (37 percent) and rural (65 percent) population. The remaining population in urban areas is served by local authorities (47 percent), local level public utilities (2 percent) and PSSPs – (11 percent). In rural areas the remaining population is mainly served by community-based organizations (CBOs). These estimates are based on a weak information base as some schemes may not be functional or number of connections may have declined, though such details are not available. In several cases, the definition of served population needs greater rigor and clarity.

Centralized public service providers in Kenya dominate the sector in terms of expenditure, though local authorities also appear to play an important role in urban areas, and CBOs in rural areas (refer figure 2). Recurrent expenditures by the service providers largely match their coverage levels. However, the share in development expenditure is significantly higher for CBOs. It is likely that the coverage by CBOs has increased through these investments, though this has proved difficult to assess due to the lack of detailed information on coverage through community-based schemes.

Figure 1: Emerging Institutional Arrangements

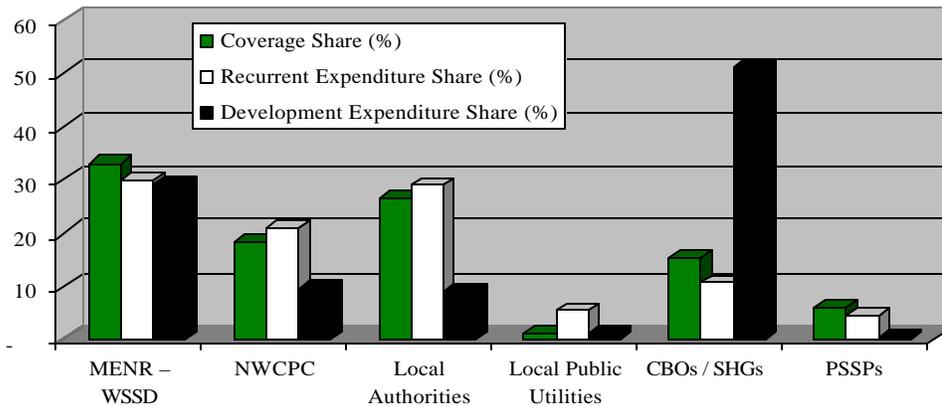


- MWRMD: Ministry of Water Resources Management and Development
- NWCP: National Water Conservation and Pipeline Corporation
- WSRB: Water Services Regulatory Board
- WSB: Water Services Board
- WAB: Water Appeals Board

The existing institutional arrangement is constrained by several factors. Sector policy development, operation/ service delivery and sector regulation have not been adequately separated. CBOs who provide services to a third of the rural population lack an adequate legal basis. Local authorities play an important role in urban areas but there is a lack of incentives for improved performance and weak or non-existent monitoring. In several urban areas, efforts have been made to develop locally owned public utilities through donor-

supported projects. However, the progress has been slow, with only two out of about ten LAs showing positive results.

Figure 2: Relative Shares for Coverage, Recurrent and Development Expenditures 2000-01 (%)



In some of the larger urban areas PSSPs play an important role both in meeting the lack of services in informal settlements, and in helping businesses or the wealthy to cope with inadequate services. However, they often operate in the context of uncertainty and rent seeking due to the lack of an appropriate legal and regulatory framework and tenure issues in the informal settlements.

The ongoing sector reforms in Kenya attempt to address key issues in institutional arrangements by restructuring the role of national sector institutions and regional/ local service providers. The new institutions envisaged under the recently enacted new Water Act include the Water Services Regulatory Board (WSRB), the Water Services Board (WSB) and the Water Appeals Board. The WSBs are to be appointed for different regions and large urban areas and will in turn contract with Water Service Providers (WSPs) for service delivery. Thus, the Government of Kenya is in the process of initiating the implementation of major reforms in institutional arrangements for water services through a separation of policy, regulation and service delivery. During this process, it will need to pay attention to the role of local authorities as well as the private sector, including small providers, and strengthening the legal basis and capacity of community-based service providers.

Implementation of reforms will need to be coordinated through a well-designed transfer program, including capacity building for different stakeholders and the development of a strong sector information system. A key aspect of implementation will be development of a program for the transfer of rural and urban schemes of national service providers as well as local authorities. While these institutional reforms are being implemented, it will be important to not lose sight of the need to enhance the coverage of sustainable access to safe

water in both urban and rural areas. A clear planning and monitoring framework will be required to link the coverage targets with the planned public expenditure.

Financial Mapping for WSS Services

Within the institutional arrangements mapped above, service providers use a number of channels and sources of funds (refer figures 3 and 4). While the GOK budget is the dominant channel for WSS sector finance in Kenya, local authorities and off-budget channels are also important. The five main channels of finance are: i) the GOK budget mainly used by the WSD of the MWRMD and NWCPC, ii) local authority budgets, relevant for those LAS that provide water services, iii) off-budget routes through NGOs mainly for CBOs, iv) internal generation by service providers – mainly by NWCPC, local utilities, CBOs and PSSPs, and v) other direct expenditures by communities and households.

Table 1: WSS Resource Flows Matrix, Expenditures in 2000-01 (In million US\$)

Channels of Finance	Public Service Providers				Other Providers		Total
	MENR	NWCPC	Local Auth.	Local Utilities	CBOs/ SHGs	PSPs	
Government of Kenya – budget ⁱ	28.5	4.0	2.7		0.9		36.0
Recurrent	16.2	0.0	0.0		0.0		16.2
Development	12.3	4.0	2.7		0.9		19.8
Local authority budget			16.8				16.8
Recurrent			15.7				15.7
Development			1.0				1.0
Off-budget donors / NGOs					18.1		18.1
Recurrent					4.5		4.5
Development					13.6		13.6
Internal Generation by WSPs		11.2		3.4	1.5	2.5	18.6
Recurrent		11.2		2.9	1.3	2.3	17.8
Development		0.0		0.5	0.2	0.2	0.9
Communities/Households					6.9		6.9
Recurrent					na		na
Development					6.9		6.9
Total Resources	28.5	15.2	19.4	3.4	27.4	2.5	96.4
Recurrent	16.2	11.2	15.7	2.9	5.8	2.3	54.2
Development	12.3	4.0	3.7	0.5	21.6	0.2	42.2

Figure 3: Channels of Finance Used by Different Service Providers 2000-01 (Ksh. million)

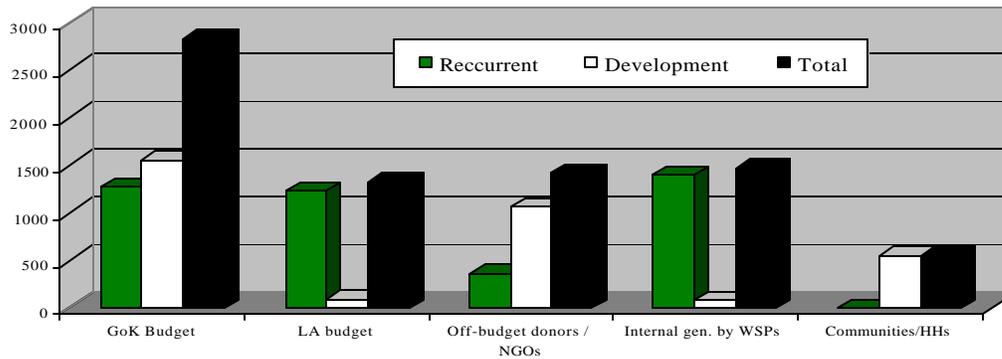
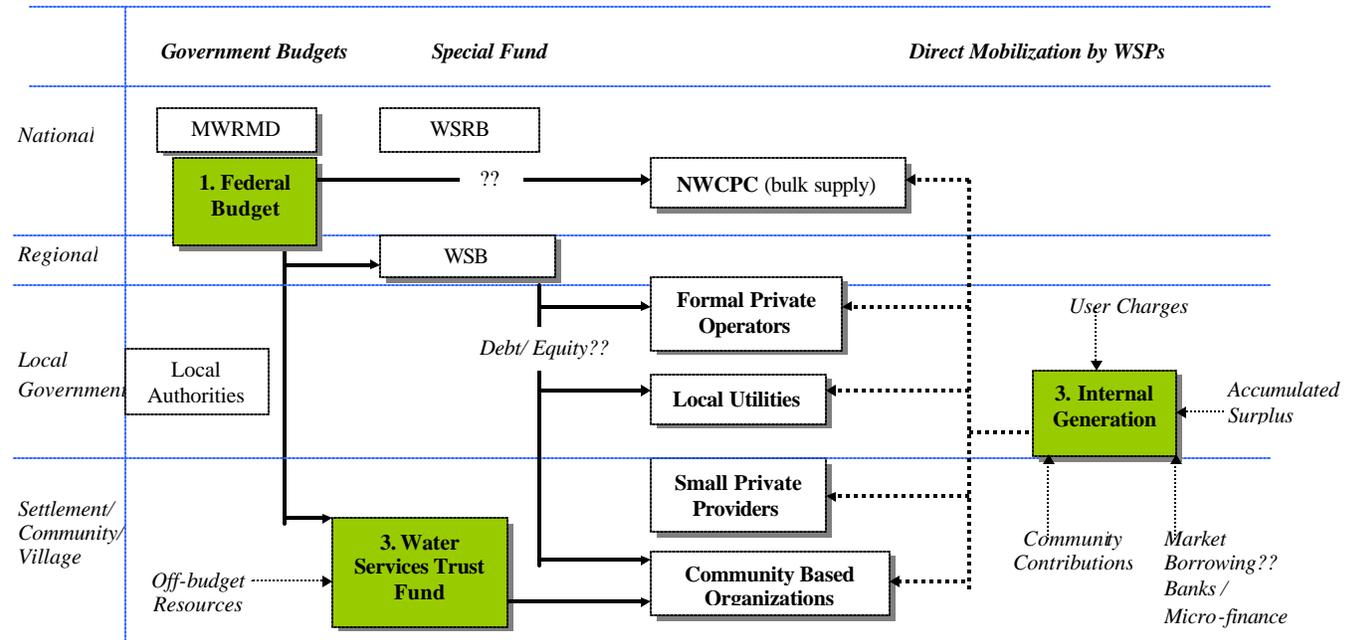
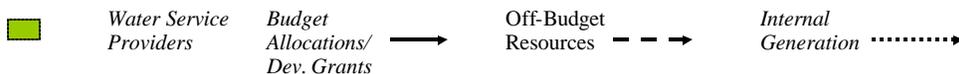


Figure 4: Emerging Financial Arrangements



- MWRMD: Ministry of Water Resources Management and Development
- NWCPC: National Water Conservation and Pipeline Corporation
- WSRB: Water Services Regulatory Board
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- WAB: Water Appeals Board



The total sector finance is estimated to be close to 100 million USD or 0.9 percent of GDP. It appears that while allocation through the GOK budget is the largest contributor (29 percent), three other sources constitute about 20 percent each: LA budgets, off-budget

contributions by NGOs and internal generation by WSPs. A significant portion of WSS sector resources is mobilized through user charges and donor support, though user charges are neither always protected nor used in a timely manner for operations. Similarly, most donor resources flow outside the framework of government decision-making.

Figure 5: User Charges and Donor Funding through Different Channels – 2000-01(%)



Some key findings include:

- *There is a preference for off-budget routes by donors/NGOs.* A large proportion of total donor resources (nearly 70 percent) is provided through off-budget support, mainly through a number of NGOs, and is devoted to development expenditures for new community-based schemes.
- *Internal generation is important but is not contributing to development expenditure.* WSPs such as NWCPC, local public utilities and the PSSPs depend on internal generation. However, their expenditure on development expenditure from this source is either non-existent or very limited.
- *Incentives for enhanced internal generation are weak.* While internal generation emerges as an important source, most WSPs lack incentives and capacity to maximize it.
- *Local authority expenditures seem to be largely from user charges.* However, these are not always protected, and an estimated 20 percent of revenues mobilized through water charges is probably used to finance other sectors /activities.
- *User charges for other public sector WSPs are generally protected but there may be cash-flow and efficiency problems.* The user charges flow upwards to the general account (for MWRMD and NWCPC to the national level and for the LAs to the LA consolidated accounts) leading to two problems:
 - i) cash-flow problems for operations, especially for regular maintenance, and ii) lack of incentives for the service provider to improve collection efficiency and service quality.

The reform framework envisages more streamlined sector finance with an emphasis on sustainable internal generation by service providers. The three main channels of finance in the emerging system are: i) Water Services Trust Fund (WSTF) for areas without adequate water services, ii) more streamlined GOK budget allocations, particularly through the new WSBs taking into account issues of equity, efficiency and coverage targets that may be set by

the government, and iii) a greater reliance on internal generation by WSPs as a main basis for sector finance. In further designing the WSTF recent experience with the WSS component in social investment funds and RWSS reforms needs to be taken into account, including aspects such as: ensuring a demand responsive approach, improved coordination with off-budget resources, exploring support to PSSPs, role of local authorities in local planning and use of output-based aid to ensure that community and private resources are not crowded out. While the WSTF is clearly positioned to receive and allocate grants, it is not clear how the WSBs will be financed through the GOK budget, and further how the WSBs will provide funds to the WSPs. A clearer understanding of whether this will be through debt or equity contributions, or simply as one time grants needs to be developed. In developing this, the rather poor experience of the GOK loans in the past needs to be reviewed.

Within this emerging scenario, there is a need to explore other potential sources of funds in the medium to long term including: i) market borrowing by WSBs and/ or WSPs, ii) potential for micro-finance, especially for the community based schemes, and iii) the possibility of private sector participation, which is more likely for efficiency improvements rather than direct finance in the initial period. To promote such resource leveraging, appropriate sequencing of activities is critical. As a first step, the need is to identify the potential borrowers within the sector and their creditworthiness and to assess the interest and potential of domestic financial sector and micro-finance industry. It is likely that the initial focus is needed on enhancing creditworthiness of potential borrowers. For example, recent inquiries regarding possibility of private sector investments in Nairobi Water Services suggest that initial investments need to be made through the public sector. However, with efficiency improvements, in the next phase the utility would be able to service debt and finance development expenditure through internal generation.

Public Finance for Water and Sanitation

Within the financial flow estimates presented above, public channels comprised 55 percent of total flows. Decision making for allocation of budgetary resources to the water sector is currently done at two levels: a) national - through the Government of Kenya budget, and b) local - through the local authority budgets. At the national level, the allocations are determined first within the PRSP and MTEF process and then within the priorities set by the MWRMD. At the local authority level there is direct consultation with the community groups as a part of the recently introduced Local Authority Service Development Action Plan (LASDAP). Both are important channels and at each level WSS appears to be important in comparison with other key sectors. However, the current institutional and budgeting framework does not provide adequate links between the sector objectives, priorities and programs, resulting in a decision-making process that is difficult to review and monitor.

Some key issues and observations on the national and local level financing processes are:

- *At the national level, compared to other social sectors, share of water is lower.* For recurrent expenditure this is justifiable with an emphasis on cost recovery. For development expenditure it is difficult to assess as estimates of resource requirements against agreed targets are not available;
- *Who receives the service delivery allocations?* Detailed analysis of the equity and coverage is difficult due to the lack of appropriate detailed budget classification. Based on limited information, in recent years emphasis on urban in development expenditures has increased.
- *The expenditure approval process and fund flow create disincentives for efficiency at local levels..* Despite the practice of district level allocations, resource utilization is hampered by a practice of an upward flow of locally collected user charges to the 'headquarters' and problem in flow of funds due both to the liquidity in district treasuries and approval processes;
- *How much is actually utilized from planned allocations?* In general, utilization of recurrent expenditure is good. However, utilization of development expenditure has also improved in recent years. This may reflect a greater realism in budget allocations due to the MTEF process;
- *Role and influence of donor funding* Donor funding, either through grants or soft credit, forms an important source of budget allocation for development expenditure, ranging from 45 to nearly 80 percent over the past five years. A large share of off-budget donor funds may reflect a lack of confidence in public governance systems and there is a case for improved coordination;
- *Local authority expenditure is mainly from user charges* unlike the significant reliance on budget allocations of other public service providers. However, there may be reverse flow of resources from water to other sectors. Interestingly, such resource outflow is more likely with the municipal councils and for Nairobi than in the rural areas;
- *Issue of large outstanding LA debt for past water investments* will need to be addressed during implementation of institutional reforms under the new Water Act. A system of appropriate incentives and financing mechanisms will be needed to ensure that the debt for water related investments is serviced properly. This is essential to enhance the creditworthiness of WSBs/ WSPs to mobilize resources from the financial markets.

While budgetary resources are important for the WSS sector, a significant proportion of the resources to the WSS sector accrue through other channels. Even for budgetary resources, user charges constitute an important component at both national and local levels. As a result, mobilization and use of financial resources in the sector can potentially be significantly affected by the institutional and regulatory arrangements, and design of financing rules and mechanisms.

Sector finance in the future will depend critically on governance of sector institutions that defines their independence and autonomy. Both are essential to introduce commercial orientation while protecting and enhancing the services for the poor. In the emerging institutional arrangements, appropriate incentives are also necessary for improved sector monitoring and transparency. This may be through the regulatory framework as well as well-designed contracts. Further, to ensure sustainability of existing and new investments, appropriate support framework for sector institutions and service providers is essential.

Appropriate design of financing mechanisms is equally critical and should be guided by three key principles: i) focus on internal cash generation by enhancing and protecting user charges, and enhancing creditworthiness of WSBs and WSPs for market borrowing, ii) to use the limited public resources in a demand responsive manner and ensuring resource leveraging, and iii) coordination of sector resources through programmatic approaches within a SWAp framework. This will require a better alignment of financing rules to enhance resource leveraging and improved targeting of subsidies.

Public finance for WSS in Kenya at present is dominated by budget decisions at national and local levels intertwined with service delivery. With the emerging institutional arrangements, however, there is a possibility of separating these, though success will depend on an appropriate transition arrangement. Thus, design of public finance allocations and mechanisms will need to focus on financing the transition arrangements and achieving a better link between budget allocations and sector outputs and outcomes.

The Way Forward

Three key activities are envisaged: i) development of guidelines to assess resource flows and benchmarking sector finance, ii) comparative assessment of sector finance in Kenya through the regional benchmarking tool, and iii) further development of resource flows analysis for Kenya based on stakeholder feedback. The first two are a part of the WSP-AF's regional thematic work. For the third activity, in the context of sector reforms, three aspects may be explored for further work in Kenya.

- support GoK in the development of an improved sector information and monitoring system and in designing the new financing framework within the emerging institutional framework;
- enhancing the resource flows analysis, with a particular emphasis on sanitation in the next phase; and
- support GOK in the design of a financing framework within the emerging arrangements under the Water Act including aspects related finance through the WSTF as well as allocation of public finance from the GOK budget to different WSBs, and possibly to WSPs.

These will be discussed with stakeholders to decide on priorities for the next phase of work.

About The Sector Finance and Resource Flows Series

The Sector Finance and Resource Flows reports are based on country studies on water and sanitation sector financing in Africa. The aim is to provide assistance to sector leaders, policy makers and development partners to help African countries meet the Millennium Development Goals on water and sanitation through: rationalizing allocation of public funds, leveraging non-public resources and improving targeting of required subsidies.

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WSP MISSION

To help the poor gain sustained access to improved water and sanitation services.

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