



The European Union Water Initiative: Final Report of the Financial Component

October 2003

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October 2003

Reference 0000474

For and on behalf of Environmental Resources Management
Approved by: _____
Signed: Submitted electronically
Position: _____
Date: October 2003

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Dominic Waughray, Sophie Tremolet, Rachel Cardone and Courtenay Cabot of Environmental Resources Management have prepared this report for the multi-stakeholder forum of the EU Water Initiative, with support from the UK Department of International Development.

The authors would like to extend their deep thanks and appreciation to all of those who have contributed freely to the process of the report's development over the past twelve months or so. This includes representatives at DFID, and DEFRA in the UK (particularly Martin Walshe at DFID and John Ballard at DEFRA), members of the EU Water Initiative multi stakeholder forum and the invaluable contributions and insights of the excellent members of the Finance Working Group.

Despite the superb level of support the authors received in the preparation of this report, all mistakes or errors remain, of course, fully their own responsibility. Further, the opinions expressed in the report are those of the authors and do not reflect those of the Department for International Development, the Department for Environment, Food and Rural Affairs, the Members of the Finance Working Group, or the members of the Multi-stakeholder Forum of the EU Water Initiative.

EXECUTIVE SUMMARY

INTRODUCTION

This report and its associated annexes are the final outputs of the Finance Component of the European Union Water Initiative.

The British Government's Department for International Development (DFID) supported the work and output of the Finance Component for the European Union Water Initiative. The process lasted twelve months, July 2002 through to July 2003. The outputs were developed in close liaison with the European Union Water Initiative's Multi Stakeholder Forum process and in coordination with a range of other international water and finance initiatives active over the same period.

The information contained in this report should be of interest to those within the European Union family of overseas aid agencies, international finance institutions, water service providers, NGOs and others active in addressing the financing challenge created by the Millennium Development Goals for water and sanitation. Relevant stakeholders in developing countries should also find the analysis and conclusions of practical use in their attempts to attract and sustain more finance in the water and sanitation sector, especially via the European Union Water Initiative. A wider audience of researchers, policy makers, private sector actors and civil society groups involved in the debate surrounding the provision of finance for infrastructure should also find this work of interest.

BACKGROUND

The European Union Water Initiative (EUWI) was launched at the World Summit on Sustainable Development in Johannesburg in September 2002. It has four regional components:

- Sub Saharan Africa
- Eastern Europe, the Caucuses and Central Asia
- The Mediterranean (including North Africa and the Middle East)
- Iberian-America

Overall, the main objective of the EUWI is to be a catalyst for action for the EU overseas aid family to more vigorously meet the millennium development goals (MDGs) for water and sanitation and for water resource management.

The goals of the EUWI are consequently closely aligned with the Millennium Development Goals for Water and Sanitation. The EUWI goals are

- To halve the proportion of people without sustainable access to safe drinking water and basic sanitation by 2015;
- To further the principles of Integrated Water Resource Management; and
- To encourage the development of water efficiency plans in all countries by 2005.

However, and similar to the MDGs, there is a clear and considerable financial challenge in achieving these goals:

- Overseas aid from within the EU cannot provide enough money alone to meet these goals.
- Overseas aid will therefore need to be used differently in the future to meet these goals: aid programmes will have to work more in harmony with each other and some aid will also have to be used to attract other, non-aid forms of finance.
- The demand for these changes in water sector finance from the EU aid family, both in style and source, needs to come more strongly from developing countries themselves.

In recognition of these challenges, a crosscutting finance component for the EUWI was created. Some key issues for the finance component to address were identified.

- How to improve the efficiency of existing and future EU aid flows to the water sector?
- How to improve the financial effectiveness of EU aid flows to the water sector?
- How to use development EU aid funding as a lever for other forms of finance for the water sector, including user and private sector finance?
- How can the EU aid family better promote the inclusion of water in poverty reduction strategy processes and in budgetary support?

The British Government took responsibility for developing the financial component for the EUWI. Working closely with the Department for Food and Rural Affairs (DEFRA), the Department for International Development (DFID) hired the consultants Environmental Resources Management (ERM) to prepare a strategy for the finance component.

The aim of DFID's support for the financial component of the EUWI was to create some common guidance for the regional components, about how to undertake a process of financial analysis that could help answer the questions raised above.

To help in the research, analysis and discussion process a Working Group on Finance was established by ERM and DFID. This consisted of stakeholders in the water, sanitation, finance and infrastructure sectors, drawn from within the EU. Participants came from both the public and private sector and from civil society groups. The Finance Working Group met three times during the finance strategy development process and the active contribution of the

participants helped greatly in shaping the outputs presented here.

This is the final report of the Finance Component. It contains the results of ERM's data analysis and literature reviews as well as the discussions that took place in the working group meetings. It also contains feedback from members of both the EUWI multi-stakeholder forum and the Finance Working Group who commented on a draft final report. The paper is accompanied by eight annexes, which include a bibliography and the membership details of the Finance Working Group.

METHOD OF ANALYSIS

To address the core finance issues identified by the EUWI, the Finance Group explored the following six questions:

1. How much extra finance will be needed to meet the water and sanitation Millennium Development Goals?
2. How much finance is currently provided by EU overseas aid?
3. How much finance is provided by the private sector and domestic tax revenue or user charges?
4. Where are the gaps and overlaps in these finance flows, in relation to meeting the MDGs for Water and Sanitation?
5. What are the key constraints, which prevent these gaps from being filled?
6. How can these constraints be alleviated, so as to lever more finance into the water sector to meet the MDGs for water and sanitation?

Data analyses were undertaken by ERM to try and answer each question. The findings (or difficulties in obtaining findings) were then discussed and explored with the Finance Working Group to create more widely rounded responses to each question. Importantly, a key underpinning assumption to the work was not to try to "reinvent the wheel" in each case, but instead to assess what existing finance or other water sector initiatives the EUWI could build on to help resolve these questions.

At DFID's request, the work focused primarily on sub-Saharan Africa. The aim was to use a regional "case study" to develop the finance strategy, and then to broaden the findings slightly, to explore issues that could be of relevance to the other regional components of the EUWI. Consequently, the aim has not been to provide a financial analysis for all regions of the EUWI, but instead to identify a common financial strategy process for each EUWI regional component to follow.

It is hoped that the process this work has followed, the questions it has raised and the answers it has obtained, can provide both a useful common start point for the EUWI as to the global financing challenge facing the MDGS for water and sanitation; and a useful methodology for the regional EUWI components to follow when examining their own financing challenges in more depth.

The main findings of the work are presented below.

HOW MUCH EXTRA FINANCING IS REQUIRED TO MEET THE WATER SECTOR MDGs?

An additional USD 9 to 30 billion per year on top of current commitments.

There is a wide range of estimates about how much finance is required to meet the future needs of the water sector. They are based on different assumptions about levels of service, types of service, and technologies. They range from zero to USD 180 billion extra per year. However, World Bank and Global Water Partnership studies have looked specifically at the financing requirements for providing basic water supply and sanitation to meet both the MDGs and Vision 21 targets. Consequently, they seem to be the most useful benchmarks to use. (Vision 21 simply extends the MDG target to 2025 to achieve a goal of basic water and sanitation for everyone).

On this basis and in addition to what is currently being spent, estimates range from a further USD 9 billion/year to meet the MDGs (World Bank 2002), up to USD 30 billion/year, to achieve water supply and sanitation for all by 2025 (GWP, 2000). Much of this is for sanitation needs. A best guess for IWRM has not been possible and it is important to realise that the figure of an extra USD9-30 billion per year, does not therefore include an IWRM component.

Section 2.2 in the main report and Annex A provide details on the range of finance estimates developed for the water sector.

HOW MUCH FINANCE IS PROVIDED BY EU OVERSEAS AID?

USD20 billion in 2001, but commitments to the sector are declining

The European aid family makes a significant contribution to the financing of water and sanitation via their overseas aid programmes. In 2001, commitments from the EU Member States and the EC totalled approximately USD 20 billion. Germany grants the highest degree of priority by allocating 10 percent of its bilateral aid to the water sector (approximately USD 380 million).

However, aid flows from the EU family to the water sector are on the decline, relative to other sectors. Despite a spike in the percentage allocated to the water sector in 2000, the average percentage of aid allocated to the water sector out of total bilateral aid from the EU remains under 5 percent.

The Monterrey Agreement, whereby the EU pledged to increase aid from an average 0.33% of GNI to 0.39% of GNI will bring an additional USD 16 billion per year by 2006. If all EU countries were to allocate 0.7% of GNI to aid, an

additional USD 48 billion per year could become available. These additional funds could make a significant contribution to meeting the financing challenge for water, but not if current funding allocations to the sector remain the same.

Section 2.3 of the main report and *Annex B* present the analysis of these finance flows in more detail.

HOW MUCH FINANCE FOR THE WATER SECTOR IS PROVIDED BY THE PRIVATE SECTOR AND DOMESTIC TAX REVENUE OR USER CHARGES?

By the private sector it's difficult to tell, but not much at all, relative to the challenge; by the public sector in developing countries, the vast majority.

At present private sector finance accounts for at best about 5 percent of all water services provided globally. The water sector receives just a fraction of total private infrastructure investments worldwide and this share has been stable or declining in recent years.

Due to the perceived high risk involved in investing in poor countries (currency, devaluation, operating and capital risks), combined with the capital intensive, long term nature of water and sanitation infrastructure, it is highly unlikely that, in the absence of increased public sector funding and external aid, large-scale private financing will be able to address the water sector challenges facing poorer regions of the world.

On the other hand, the domestic public sector in developing countries provides the large majority of financing for the water sector. The scale to which the domestic public sector must be relied on to provide access to water supply and sanitation finance (both for investment and for recurrent financing needs) cannot be understated.

Section 2.3 of the main report and *Annex B* present the analysis of these finance flows in more detail.

WHERE ARE THE GAPS AND OVERLAPS IN THESE FINANCE FLOWS, IN RELATION TO MEETING THE MDGs FOR WATER AND SANITATION?

There are large finance gaps and misallocations in relation to meeting the water and sanitation MDGs. In terms of aid, even if the Monterrey commitments are fully met, based on current sector allocation trends, they will provide less than a tenth of the lower bound estimate of the extra finance required to meet the water sector MDGs. Furthermore, those countries which are most in need of aid finance to help meet the water sector MDGs, tend to get less support from the EU aid family. In terms of the public sector, governments spend tiny amounts of their budgets on pro-poor water sector issues. International private sector finance also steers clear of explicitly pro-poor water sector initiatives.

There is a gap in finance for the water sector both in terms of overall levels and in terms of sectoral allocations.

Even if the Monterrey goals were met, a continuation of 5 percent of EU aid being spent annually on water would equate to just US\$0.8 billion of the extra US\$16 billion in aid available. This is some way short of the lower bound estimate of the finance challenge facing the EUWI of US\$9 billion extra per year.

Further, the EU aid that is currently allocated to the water sector does not necessarily go to where it is needed most, relative to the EUWI targets. Using the 1990 WHO GMP survey¹, the countries in sub Saharan Africa with least access to water are Mauritania, Ethiopia, and Guinea. The countries with least access to sanitation are Benin, Mauritania and Ethiopia. However, the countries receiving the most EU AID for water are Ghana, Burkina Faso and Tanzania, which are much less in need. The same study calculated that only one-fifth of the assistance on offer was directed towards sanitation.

In terms of domestic sources of finance, studies² show that governments in developing countries have been found to spend just 1-3 percent of their annual budgets for the water sector on low-cost water and sanitation services (services for the poorest). The international private sector too, when it is involved, tends to mobilise finance for larger, predominately urban initiatives or large scale hydraulic investments. Whilst these are important, the issues of finance for smaller town or rural water and sanitation services receive less private sector attention.

Often EU aid does not help to re-orientate these patterns of domestic and private finance flows. Most aid assistance is currently provided via bilateral grants, with limited coordination between Member States for defining priorities and identifying gaps.

Section 2.4 of the main report and *Annex B* provide analyses of gaps and overlaps in the flows of finance to the water sector in more detail.

WHAT ARE THE KEY CONSTRAINTS, WHICH PREVENT THESE GAPS FROM BEING FILLED BY NON-AID FINANCE?

Broadly, more finance is deterred from entering the water and sanitation sector in developing countries because of commercial risks, political risk and governance issues, a lack of good projects and a lack of national capacity. Out of these, unsatisfactory governance seems to be the biggest constraint.

¹ WHO/UNICEF. 2000. "Global Water Assessment 2000." WHO Geneva

² S. Annamraju, B.Calaguas & E.Gutierrez, 2001, "Financing water and sanitation, Key issues in increasing resources to the sector: A WaterAid briefing paper" Water Aid, UK

Why do these gaps exist? Why is the water sector not currently attracting the levels of finance needed to meet the challenge set by the MDGs?

Putting aside the issue of the overall size of aid flows, which requires a political commitment to allocation rather than further research analysis, attention was given to identifying the range of other potential sources of finance available to the water sector and the constraints that seemed to hinder these sources from being attracted in greater volume.

This part of the analysis was undertaken with close regard to the work produced by the World Panel on Finance for Water Infrastructure¹. Broadly in line with the Panel's wide range of findings, the following financing sources and mechanisms for the water sector were identified:

- User finance (via tariff revenues)
- Environmental charges
- Grants
- Loans
- Mixed credits and export funds
- Output based aid
- Micro-finance
- Bond markets
- Equity markets
- Direct private Investment
- Public private partnerships and private finance initiatives
- Voluntary finance schemes
- Sector wide approaches and sectoral funds

Broadly, this list covers finance sources drawn from domestic tax revenues, user finance and subsidies; international private sector sources; voluntary sources; and the different types of vehicle on offer for using aid and public finance more effectively.

Four sets of key constraints, which could explain why these sources, or combinations thereof, may not be attracted to the water sector as greatly as they could, were also identified. Again, broadly in line with the Panel's findings, these constraints were found to be:

- Commercial Risk
- Political Risk and Governance Issues
- A Lack of Good Projects
- A Lack of National Capacity

¹ Winpenny, James. 2003. "Financing Water for All: Report of the World Panel on Financing Water Infrastructure." GWP, Stockholm

Commercial risks may include the issues facing the private sector in their decision to invest in the water services market, such as foreign exchange risk (due to revenue generated in local currency), contractual risk (length of water sector contracts against a backdrop of potential uncertainty), operational risk (level of ability to introduce efficiencies in billing, collection, leakage and other cost controls), construction or capital investment risks (due to lump sum or fixed price contracts).

Political risk and governance issues reflect the fact that political interference and unstable regulatory regimes (with respect to allowing tariff changes, enforcement of payments, providing regulatory clarity, allowing sub-sovereign decision making, a lack of flexibility in adapting to changing cost characteristics, poorly harmonised policy, poorly developed local capital markets, difficulty in mobilising local currency guarantees etc) can alter the operating environment hugely, impacting on the ability or desire to source finance for water projects.

A lack of good projects encapsulates a number of constraints to attracting more finance into the sector: the fact that project preparation requires high up front costs in the water sector; that complex issues have to be addressed with respect to ensuring the financial sustainability of the project rather than identifying simply initial capital costs alone; that prestige projects may get more attention than those projects which focus more on the meeting the water and sanitation MDGs; that the identification of appropriate project counterparts can be difficult, especially in relation to aggregated small town projects; and that designing appropriately demand-driven projects for the poor can be quite complicated.

A lack of national capacity reflects the fact that capacity constraints can be present in the changing role of the public sector, especially at sub-sovereign levels; in the local private sector and in wider civil society. With limited capacity and experience in each of these areas, the ability to design, implement, regulate, advocate or manage new water sector projects is constrained and the delivery of more finance is made more problematic.

Sections 3.2 and 3.3 of the main report and Annex D provide more details on the subject of identifying sources of finance and the constraints that seem to stop them being attracted more successfully into the water sector.

HOW CAN THESE CONSTRAINTS BE ALLEVIATED, SO AS TO LEVER MORE FINANCE INTO THE WATER SECTOR TO MEET THE MDGs FOR WATER AND SANITATION?

There are many ways in which EU aid might be used much more smartly, to help water users, water service providers, public authorities, and the donor's themselves, attract much more finance into the sector, to help meet the MDGs. Importantly, these approaches are not necessarily water sector specific and do not necessarily require "reinventing the wheel".

The working assumption of the EUWI finance strategy is that adequate sources of non-aid finance do exist to help meet the water sector MDGs, but that the water sector in developing countries fails to attract and retain them, mainly because of the constraints identified above.

Consequently, rather than lobbying for simply more water sector EU aid, might it be the case that existing aid commitments could be used more effectively if they were targeted instead toward alleviating the constraints that stop these other sources of finance becoming available for investment in the water sector?

Thus, the study moved on to look at how best to target EU aid to alleviate these constraints in more detail. This was undertaken from the perspective of the four main water sector stakeholders who require more effective finance strategies:

- Water users (community based organisations etc.)
- Water service providers (from a local, state or national perspective)
- Government (at sovereign and sub sovereign levels)
- EU Development Agencies (those EU agencies who provide finance with a water sector commitment)

Water Users

Water users face broadly governance, capacity and project preparation constraints.

- A lack of cash and credit
- A lack of demand focused projects
- A lack of local capacity
- A lack of decentralised governance

EU aid could be better used to ease these constraints in the following ways:

- By supporting work on more appropriate, pro-poor tariff and targeted subsidy regimes
- By promoting output-based aid projects for communities
- By providing funds and design support for community financing and credit schemes
- By providing funds and technical support to design better demand-focused, financially sustainable projects and programmes
- By supporting capacity building initiatives within civil society to form water user groups, community groups and so on, to become more effective advocates for policy change or service improvement

In this way, EU aid could be used to stimulate water users to provide their own finance, through paying for the provision of targeted subsidies (especially for connections); starting up community-financing and credit schemes; helping to design more demand-focused projects that people

actually want and will pay for; promoting output based tariff changes; and developing capacity to form water user groups who can better articulate their demands to service providers, or be better represented within local decision making institutions for water and sanitation.

Water service providers

Water service providers in developing countries face broadly commercial, governance and capacity related constraints in improving their service to the poor.

- Operating deficits
- Lack of cash for reinvestment or expansion
- Inability to raise cost effective finance
- Lack of capacity in finance and management capabilities
- Lack of autonomy

EU aid could be used to ease these constraints in the following ways:

- Providing technical assistance
- Supporting studies into price reform
- Supporting capacity building initiatives for the water service providers
- Helping water service providers to raise other forms of finance

In this way, EU aid could be used to better help water service providers in developing countries to leverage more finance for investment and expansion of their operations through tariff and subsidy reform (and improved billing and collection procedures), accountancy improvements, and through helping to stimulate a mixture of finance sources including loans, raising bonds, encouraging equity stakes and direct private investment in their organisations. Aid can help to do this by providing various forms of technical assistance in areas of strategic corporate development and capacity building; by helping to provide, identify and negotiate affordable loans; by underwriting elements of risk attached to these loans; and by encouraging equity investors through the use of aid to offset ill-liquidity premiums or low returns etc. Wider reform programmes related to market development and the public sector will also be of direct use to the water service provider, if they are well designed and targeted.

Government

Governments at sovereign or sub sovereign levels in developing countries face broadly governance and capacity related constraints to attracting more finance into the water sector.

- A political reluctance to reform
- Budgetary constraints due to competing demands
- A lack of a long term strategy for the sector, or effective articulation of this strategy
- A lack of understanding to adjust policy to better access other forms of finance
- A lack of capacity to adjust to new roles and responsibilities

By working with the relevant line responsibilities for the water services sector, or with those with finance responsibilities in state or national government, EU aid could be used to ease these constraints in the following ways:

- To provide guidance on possible reform pathways and to engender a political will for change
- To develop financing plans
- To support good project preparation
- To build capacity
- To improve tariff and subsidy regimes
- To provide specific technical assistance
- To leverage cheaper loans
- To underwrite risk
- To develop local capital markets
- To enhance interest from equity investors

In this way, EU aid could be used to better help introduce wider financial reform and financing possibilities into the water sector, both in terms of strategy and capacity development and in terms of stimulating local markets, underwriting risk and promoting access to wider forms of international financing options. Importantly, many of these activities do not have to be sector specific to water, but simply designed well enough to ensure a positive impact on the water sector.

EU Development Agencies

EU Development Agencies include those bilateral donors within the fifteen EU member states as well as the EC family of development agencies and programmes and European-related finance institutions (including the EBRD and the EIB).

The EU Development Agencies face broadly governance and project preparation constraints.

- Untying aid flows
- Improving the leverage ratio of their aid
- Reducing transaction costs for recipient governments through improving the harmonisation and complementarity of their aid efforts
- Sharing information and experiences
- Working together to stimulate demand for more pro-poor water and sanitation investments from recipient governments.

Water sector professionals within the EU aid agencies could use their time to ease these constraints in the following ways:

- By creating a sense of peer pressure such that all in the EU family become coherent with their commitments to wider international (and water sector) agreements, including on the untying of aid and others.

- By discussing gaps and overlaps in aid flows on a country basis, in relation to gradually refining programmes to better meet the MDGs (or Vision 21) for water and sanitation
- By agreeing that their comparative advantage lies in accessing cheaper finance for water services for poor people and not in water service provision; and then acting upon this agreement
- By agreeing on the use of standard approaches for water sector financing, both in terms of definitions (for DAC records) and in approaches to key issues such as a shared understanding of good water governance; correct levels of cost recovery; the role the private sector and private finance can play; the usefulness (or not) of sectoral funds or sector wide approaches; and the usefulness (or not) of existing instruments to attract private sector finance into the water sector
- By working together to raise awareness within recipient governments of the wider developmental role of water and sanitation, in order to encourage both a stronger emergence of the water sector within the PRSPs and also a clearer demand for more strategic water and sanitation investments

In this way, instead of deploying resources to administer a series of loosely related aid programmes for the water sector, administrative costs (staff time, meetings etc) of the EU development agencies could be better spent focusing on changing different institutional behaviours and preferences within the EU aid family and moving from service to finance provision. The aim would be to mould these divergent approaches into a common (or much more complementary) set of goals and behaviours for the use of aid finance for the water sector.

Section 3.4 of the main paper analyses these stakeholder issues in much more depth.

Importantly, it must be recognised that the EUWI and its financing components will not work in isolation. With a strong emphasis on not “reinventing the wheel”, *Section 4* of the main paper, and *Annex D*, detail the range of building blocks that the EUWI finance strategy can refer to, in order to place the work within the context of the wider changes in aid architecture. These building blocks include:

- *Country-specific water initiatives*, which have been developed by one donor in particular or for a particular recipient country or region.
- *Global water initiatives*, which tend to act as knowledge networks and have accumulated considerable expertise on the water sector;
- *Non-water specific financial initiatives*, which have developed innovative financial vehicles that could potentially be tapped into by the EUWI;
- *Water specific financial initiatives*, primarily the proposed EU Water Fund;
- *Water-specific policy initiatives*, focusing on the most recent initiatives that form the conceptual basis of the EU Water Initiative;

- *Policy initiatives and international agreements* that shape the way in which development assistance can be provided globally and in the EU;

This information may also be useful to help water stakeholders find out more information, or access knowledge networks or funding sources on possible ways to alleviate these sets of financing constraints.

Finally, *Annex E* provides a specially prepared specific guidance note as to what good water governance in a country may look like. The aim is to provide an informal marker against which a government may assess its level of perceived “political risk”, which may be acting as a constraint to the leveraging in of wider forms of finance

PROCESS

A key underpinning aim of the finance component workstream was to discretely extract and present the *process* of the analysis as well as its outputs. This was felt to be important, so that

- Other regional components of the EUWI could follow the same process as was undertaken for the sub Saharan Africa “case study”, thus creating a comparable suite of regional analyses across the EUWI.
- Developing country governments who may be potential partners of the EUWI could also use the finance component’s work to provide them with clear guidance on how to develop their own analyses of water financing gaps, constraints, needs and potential best uses of finance sources. In this way the work might help them more effectively stimulate their own demands for EUWI supported projects and programmes.

Consequently, *Annexes B and C* to the main paper also provide “how to” material, explaining the process of data analysis undertaken by the finance component.

1

INTRODUCTION

1.1

THE EUROPEAN WATER INITIATIVE AND ITS FINANCIAL STRATEGY

The European Union Water Initiative (EUWI) was launched at the World Summit on Sustainable Development in Johannesburg in September 2002.

The overall objective of the EUWI is to be a catalyst for action for the EU overseas aid family to more vigorously meet the millennium development goals (MDGs) for water and sanitation and for water resource management. As a consequence, the goals of the EUWI are closely aligned with the MDGs for Water and Sanitation.

The EUWI goals are:

- To halve the proportion of people without access to safe drinking water and sanitation by 2015
- To further the principles of Integrated Water Resource Management
- To encourage the development of water efficiency plans in all countries by 2005.

To implement these goals, the EUWI has four regional components:

- Sub Saharan Africa
- Eastern Europe, the Caucuses and Central Asia
- The Mediterranean (including North Africa and the Middle East)
- Iberian-America

However, and similar to the MDGs, there is a clear and considerable financial challenge in achieving these goals.

- Overseas aid from within the EU cannot provide enough money alone to meet these goals.
- Overseas aid will therefore need to be used differently in the future to meet these goals: aid programmes will have to work more in harmony with each other and some aid will also have to be used to attract other, non-aid forms of finance.
- The demand for these changes in water sector finance from the EU aid family, both in style and source, needs to come more strongly from developing countries themselves.

The EU overseas aid family is a term used throughout this report to refer to the collection of agencies and institutions within the EU involved in the provision of overseas aid to poorer countries. This family includes the 15 bilateral aid agencies of the Member States, other bilateral government departments that may provide environmental or other forms of overseas support; the EC and its various multilateral aid agencies, the European Investment Bank and the European Bank for Reconstruction and Development. The term family is used to capture the close relationship these agencies inevitably have with one another, whether they be fruitful or frustrating.

To help provide guidance on common solutions to these challenges for each regional component, a crosscutting financial component to the EUWI has been established.

The British Government has taken the responsibility for developing the financial component for the EUWI. Working closely with the Department for Food and Rural Affairs (DEFRA), the Department for International Development (DFID) hired the consultants *Environmental Resources Management* (ERM) to undertake a process and prepare a report delineating this financial strategy.

The aim of DFID's support for the financial component of the EUWI is to create some common guidance for the regional components, about how to undertake a process of financial analysis that could help address the challenges raised above.

To help in the research, analysis and discussion process, a Working Group on Finance was established by ERM and DFID. This consisted of stakeholders in the water, sanitation, finance and infrastructure sectors, drawn from within the EU. Participants came from both the public and private sector and from civil society groups. The Finance Working Group met three times during the finance strategy development process and the active contribution of the participants helped greatly in shaping the outputs presented here. *Annex G* to this report provides more details on the membership of this group.

To address the core finance challenges identified by the EUWI, the process posed itself the following six questions:

1. How much extra finance is needed to meet the water and sanitation Millennium Development Goals?
2. How much finance is currently provided by EU overseas aid?
3. How much finance is provided by the private sector and domestic tax revenue or user charges?

4. Where are the gaps and overlaps in these finance flows, in relation to meeting the MDGs for Water and Sanitation?
5. What are the key constraints, which prevent these gaps from being filled?
6. How can these constraints be alleviated, so as to lever more finance into the water sector to meet the MDGs for water and sanitation?

Data analyses and discussions were then undertaken by ERM to try and answer each question. The findings (or difficulties in obtaining findings) were then debated and explored with the Finance Working Group to create more widely rounded responses to each question. It is this process that is reflected in this report.

Importantly, a key underpinning assumption to the work was not to try to “reinvent the wheel” in each case, but instead to assess what existing finance or other kinds of initiatives in aid architecture, the EUWI could build on to help resolve these questions.

At DFID’s request, the work focused primarily on sub-Saharan Africa. The aim was to use information about this region as a “case study” to develop the finance strategy, and then to broaden the findings slightly, to explore issues that could be of relevance to the other regional components of the EUWI. Consequently, the aim has not been to provide a financial analysis for all regions of the EUWI, but instead to identify a common financial strategy process for each EUWI regional component to follow.

It is hoped that the process this work has followed, the questions it has raised and the answers it has obtained, can provide both a useful common start point for the EUWI on the global financing challenge facing the MDGS for water and sanitation; and also a useful methodology for the regional EUWI components to follow, when examining their own financing challenges in more depth.

1.2 OBJECTIVES OF THIS REPORT

The objective of this report is to help provide guidance to the regional components of the EUWI on how best to undertake a financial analysis of the problems and possible solutions in their region. It provides some global figures as a start point and then uses a case study investigation (sub Saharan Africa) as a model for how to undertake a regional financial analysis.

The report is split broadly in two:

The financial challenge and how to measure it

Firstly, there is a section that explores the financial challenge. Taking a global overview, this section looks at the scale of the overall financial challenge if the EUWI goals are to be met. How much finance is needed? How much is currently provided by the EU aid family? How much is provided by users, the local domestic sector and the private sector? Where and how big are the gaps? Broadly, this section addresses the first four of the six questions the finance component posed itself.

Moving from a global to a regional perspective, data on sub Saharan Africa are then used to provide some case study material. To show how the case study material was created, *Annexes A, B, and C* explain what kinds of questions were asked; where the data sources and indicators can be found; and how best these data may be analysed.

The objective of the financial challenge section and its related annexes is therefore to set the global scene on how much finance is needed as an overall start point; and then to provide a series of signposts as to how best to investigate specific financial challenge issues for a regional component, using sub Saharan Africa as a case study.

Meeting the financial challenge

Secondly, there is a section that looks at how to meet this financial challenge. It explores a wide range of possible sources of finance for the water sector, accepting that grant aid from donors alone will not be enough; the reasons why there are constraints to attracting more of these others sorts of finance to the water sector; and how support from the EU aid family may be best used to help overcome these constraints.

Discussions on the sources of finance and the types of constraint were explored with the Finance Working Group in a reasonably generic manner, so it is hoped that the findings in this section prove to be a useful start point for the discussions in most regional finance components. Importantly, this section also tries to highlight how solutions (using EU aid more smartly to overcome these wider financing constraints, so as to attract the required amount of finance into the sector to help met the EUWI goals) need not involve setting up new initiatives or mechanisms, but instead may involve more harmony with, or building upon, existing ones.

To support this section, *Annexes D and E* provide

- Detailed explanations about the different sources of finance available (from illustrating the pros and cons of different types of tariff to

explaining about international bond markets and private finance initiatives)

- Information on the wide range of water sector or broader finance and infrastructure initiatives, which may prove to be useful starting blocks for regional finance components to build upon.

The objective of the *Meeting the Financial Challenge* section is therefore to explore the wider range of finance sources that may be available to a regional water sector; to highlight some common constraints as to why they may not be currently attracted to the sector; and to suggest some ways in which EU aid may be better targeted to overcome these constraints, thus acting as a lever to attract much larger sources of finance. Importantly, in using aid to overcome these constraints, the section also highlights how there are many existing initiatives for the regional finance components to build upon, rather than suggesting the EUWI creates new mechanisms.

1.3

METHODOLOGY

This analysis brings together the results of background research from ERM and a set of wider discussions that took place during the course of three Finance Working Group meetings. The initial focus of the analysis was on the sub-Saharan regional components: the research was based upon Sub-Saharan African data and then presented to EECCA regional representatives, in order to assess its suitability to other regional components. Other key parts of the methodology are discussed below.

Literature review

As part of the research, ERM examined the existing literature on the challenges facing the water sector, as well as soliciting opinions from a variety of sources about public, private, and civil society structures for water management. A complete list of data sources can be found in *Annex G*.

Working group meetings

The financial strategy component convened a working group as part of the EU Water Initiative Multi-Stakeholder Forum to discuss issues related to financing for the water sector. Between 2002-2003, three working group meetings were held, all in London, with a variety of participants from the public, private, and civil society sectors. Working group members availed themselves to the process by actively contributing comments and suggestions, as well as providing additional research support when needed.

Liaison with the wider EUWI process

During the research process, ERM consultants enjoyed attendance at several

EUWI multi stakeholder forum meetings and related events such as the 3rd World Water Forum and the Kiev Environment for Europe Conference. These opportunities provided a chance to present, discuss and evolve work in progress. This created significant benefits, allowing ERM to develop the materials to best suit the needs of the multi-stakeholder forum and the regional components, as expressed through feedback and discussion.

World Panel on Financing Water Infrastructure

A key initiative that came to fruition during the lifetime of the finance component's work, was the delivery of the final report from the GWP/WSC supported World Panel on Financing Water Infrastructure: Winpenny, James. 2003. "*Financing Water for All: Report of the World Panel on Financing Water Infrastructure.*" GWP, Stockholm (the so called Camdessus Report, after the Panel's chair Michel Camdessus).

The finance component team coordinated closely with this important initiative. In September 2002, a first draft of the work from the EUWI finance component was submitted on request to the Panel; and the Panel's Secretary was a member of the Finance Working Group. In this manner complementarity between the two emerging reports was ensured. However, the work of the EUWI finance component was also mandated to try and move the Panel's finance debate forward into practical implementation. Hence, while this report picks up on many of the Panel's findings, it also attempts to place them, and other recommendations, within the practical context of what might be a set of workable tools for the EU aid family to support, which could help to leverage the desired level of finance into the water sector.

1.4 **STRUCTURE OF THIS PAPER**

The remainder of this paper is structured as follows:

Section 2 explores the financial challenge facing the water sector at a global and regional level, and the challenge facing the EUWI: how much financing is (and will be) required? How much is currently provided? Where are the gaps and overlaps?

Section 3 explores the wider sources of finance that may be available for the water sector; common constraints, which may stop these sources of finance being attracted; and the ways in which EU aid might be better used to overcome these constraints.

Section 4 summarises the types and range of initiative that the EUWI finance components could build upon.

Section 5 provides a short set of concluding remarks.

In addition, a series of seven Annexes provide more detailed support to the text.

Annex A contains a summary of existing estimates of the current and projected funding needs for the water sector.

Annex B contains detailed and practical guidance on how the work (and process) of the finance component was undertaken. It provides detailed guidance therefore on how to develop regional finance strategies for the EUWI.

Annex C contains advice on identifying and using data sources, developing indicators, a methodology for tracking data, and an assessment of the information gaps that would need to be overcome in order to implement a regional finance component on the basis of sound knowledge.

Annex D provides a detailed overview of the sources of finance that can be available to the water sector; and background information on the policy environment and potential building blocks for the Initiative.

Annex E contains some guidelines, developed by the Working Group, on what good water governance may look like from a finance perspective. It is hoped that they prove helpful in mitigating one particular type of constraint that was identified as difficult to tackle – that of political risk and poor water governance.

Annex F contains a bibliography

Annex G includes a list of Working Group members.

2.1 *INTRODUCTION*

The objective of this section is to ascertain how much extra finance is needed to meet the goals of the EUWI; and then to indicate how best each regional component of the EUWI might investigate their specific financial challenge issues, using sub-Saharan Africa as a case study.

To meet this objective four questions are addressed.

1. How much extra finance is needed to meet the water and sanitation Millennium Development Goals?
2. How much finance is currently provided by EU overseas aid?
3. How much finance is provided by the private sector and domestic tax revenue or user charges?
4. Where are the gaps and overlaps in these finance flows, in relation to meeting the MDGs for Water and Sanitation?

Question one is addressed in a global context and the findings should remain valid as a start point for each of the regional components; questions two through four are looked at a little more specifically from a sub-Saharan Africa viewpoint, but the *process* of the investigation – as detailed in *Annexes A* and *B* – provides a common approach for each of the regional components to follow.

2.2 *HOW MUCH EXTRA FINANCE IS NEEDED TO MEET THE GOALS OF THE EUWI?***2.2.1** *Introduction*

Estimating the financial challenge for meeting the targets of the EUWI is important in order to understand the magnitude of the task that the EU aid family has set itself.

Several exercises have been undertaken to assess the financial challenge facing the water sector ⁽¹⁾ in developing countries. *Annex A* summarises the key findings of these studies.

(1) For the purposes of this report, “water sector” means not only water and sanitation services but also, as far as possible, activities carried out at all levels, including wastewater treatment, irrigation, flood defence, water sector policy, management of water resources, water education, etc. This definition is based on the OECD DAC’s definition for the water sector, although the DAC does not include flood defence in its standard definition. For a more detailed description of the water “sub-sectors” included in the OECD database, please refer to *Annex B*.

Two issues quickly become apparent.

First, that there is a wide range of financing estimates. The range exists, in part, due to the range of end points against which different estimates have been calculated (e.g., assumptions about population growth, estimates of current coverage ratios, or minimum level of wastewater treatment achieved. Studies range from zero to USD180 billion extra per year.¹ Indeed, the wide variation in these estimations may affect their credibility and can serve to undermine the argument for prioritising water investments overall, as for example the range of reactions to these report show.

Second, due to a lack of quality and consistent data across these estimates, it is not possible to definitively state the magnitude of global financing that is needed. It is clear, however, that financing needs are large, and that business-as-usual will not be sufficient to meet them.

As several parallel initiatives are underway to try and improve the quality of these estimates, including the Millennium Development Project, it was not considered necessary for the EU Water Initiative to derive its own estimates of the financing challenge, from either a global or a regional perspective. For this reason, no specific methodology for assessing the overall financial need has been created. Instead, a “best-guess” zone at the global level has been drawn from the most appropriate existing studies. The aspiration is that all components of the EUWI should then use this best guess zone when quoting what the finance challenge will be for the EUWI at the global level and then adapt it, if necessary, to suit their own regional perspective.

2.2.2 *Identifying a “best guess” zone for the scale of the financial challenge*

Estimates of the financial challenge facing the water sector broadly revolve around calculating the cost of meeting two sets of targets, the water sector MDGs or Vision 21’s Framework for Action.

The text boxes below provide more information on each

(1) These figures refer to the findings presented in the 2001 “Zedillo” and the 2003 “Camdessus” reports, respectively; see boxes 2.4 and 2.5 later in this section for more details.

Box 2.1

The Millennium Development Goals (MDGs)

The MDGs were developed during the 1990s, building on the experiences and demands of development agencies and recipient countries, and expressed at international development conferences. The international development community generally accepts these as a framework for measuring development progress ⁽¹⁾

The MDGs for water supply and sanitation fall under Goal 7, Target 10: To halve, by 2015, the proportion of people without sustainable access to safe drinking water and basic sanitation. Prior to the World Summit on Sustainable Development in 2002, sanitation was not included in this goal, and was instead captured as part of a wider slum improvement goal (goal 11).

Box 2.2

Vision 21

Vision 21⁽²⁾, on the other hand, is a global, participatory, people-centred process of envisioning what the world's water and sanitation situation should be like in 2025. It was developed to provide a context to the First World Water Forum and was spearheaded by the World Water Commission and many other prominent water NGOs and development agencies. As part of the Second World Water Forum, the Vision was expanded upon by the Global Water Partnership, which launched a "Framework for Action", also based on a participatory approach. This provides an action plan to meet the goals and targets set forth in the Vision at country, regional, and global levels.

Vision 21 and its Framework for Action stress the need for water sector improvements as part of a broader development strategy. It has the same objectives for water services as the MDGs up to 2015, but extends further to 2025 a goal of basic water and sanitation for everyone. Importantly, Vision 21 and the MDGs are not mutually exclusive: both processes were developed in collaboration with the water development community. However, the language in Vision 21 is perhaps not as precise as the MDGs: for example, Vision 21 calls for "adequate" sanitation rather than "basic sanitation".

Both the MDGs and Vision 21 focus mostly on water and sanitation service delivery goals. The goals of the EUWI are closely aligned here with the MDGs.

However, both the MDGs and Vision 21 are hazier in relation to Integrated Water Resources Management (IWRM) issues, which also form part of the EUWI's goals.

For example, while the principles of IWRM are included in both the MDGs and Vision 21 (the Plan of Implementation for the MDGs that emerged from the WSSD specifically refers to the need for both IWRM and water efficiency plans – see box 2.3 below), neither process identifies clear and universal targets and indicators for IWRM.

(1) The Millennium Development Goals Website is http://www.developmentgoals.org/About_the_goals.htm

(2) GWP. 2000. "Vision 21: Towards Water Security: A Framework for Action." GWP, p. 43.

Box 2.3

IWRM and Water Efficiency Plans in the WSSD Plan of Implementation

Section IV of the *Johannesburg Plan of Implementation* calls for action to reverse the current trend in natural resource degradation, and to implement strategies that include national and regional levels to protect ecosystems and integrated resource management. To achieve this, the Plan identifies meeting the MDG for safe drinking water, as well as basic sanitation, and to mobilise finance to meet the needs of the poor and are gender sensitive. It also identifies developing Integrated Water Resource Management and water efficiency plans by 2005, with support to developing countries, through actions at all levels to: develop and implement national and regional strategies, introduce measures to improve efficiency of water infrastructure, employ a range of policy instruments (with a pro-poor focus); develop programmes for mitigating extreme-water related events; support diffusion of capacity building for non-conventional water resources and conservation; support efforts for energy efficient desalination of water, and water recycling; facilitate public private partnerships that give priority to the needs of the poor; support developing countries and countries in transition in their efforts to monitor and assess water resources; improve water resources management and scientific understanding of the water cycle, and to promote effective coordination amongst the international and inter-governmental agencies working on water-related issues.

Source: http://www.johannesburgsummit.org/html/documents/summit_docs/plan_final1009.doc

This lack of precision about targets for IWRM as part of the MDGs is problematic, as it means that estimates as to the financial challenge of IWRM are much less advanced. Clearly, IWRM is a complicated cost to assess, as it incorporates all of the many economic and social activities that either centre on, or are affected by, water resources. Often, the current and projected amounts that are required to sustain the different components of a river basin, including irrigation and flood control, hydropower, industrial effluent, and environmental protection, are not taken into consideration in the various MDG financing estimates. However, although there is a general lack of consistent estimates for IWRM as part of the MDGs, the Vision 21 process does provide some basic estimates for the EUWI to work with.

In summary, those studies that looked at financing the MDGs for water and sanitation were reviewed to provide a best guess zone for the financial challenge facing the EUWI on water services issues; and Vision 21's Framework for Action was reviewed to derive a best guess estimate of the financial challenge facing the EUWI on IWRM issues.

2.2.3

How much finance is needed to meet the MDGs for water and sanitation?

Several studies have considered the cost of meeting the MDGs for water and sanitation. These include:

- Water Aid 2002
- World Bank 2002
- World Panel on Financing Water Infrastructure 2003
- Lehman Brothers 2002

A summary of the different projections made in these studies, and their underlying assumptions, is presented in *Annex A*.

Based on these studies, the best-guess zone for achieving the MDG targets – which are for low-cost, basic water supply and sanitation – indicates that an **extra USD 9-30 billion per year will be required between 2000 and 2015**. Importantly, these estimates assume that of this amount, considerably more will have to be spent on sanitation over water supply. (Estimates for meeting the water supply target range from an USD8 –USD13 billion per year; for sanitation, estimates can range up to USD17 billion.)

Box 2.4 *Higher cost estimates of the financial challenge*

An extra USD 180 billion per year has recently become oft cited as the required cost to meet the financial challenge in the water sector. This comes from the report of the World Panel on Financing Water Infrastructure. However, this estimation is based upon meeting the Framework for Action goals ⁽¹⁾ This amount thus represents the indicative annual total resources needed for water services for developing countries over the period 2000 to 2025 based on the population projections used in the Vision and includes drinking water, sanitation, municipal wastewater treatment, industrial effluent, irrigated agriculture and environmental protection. Hydropower is excluded; however a 15% allowance is included to cover O&M and replacement costs. Consequently, this is a much larger amount than that needed to meet the less ambitious MDGs for water and sanitation – i.e. the EUWI targets.

Box 2.5 *Lower cost estimates of the financial challenge*

In the 2001 report from the UN High Level Panel on Financing for Development, chaired by Mr. Ernesto Zedillo, it was reported that with current spending for the water sector at USD 25 billion a year and current projections of future needs at between USD 10- 29 billion a year, “additional expenditure should not be needed” to achieve the MDGs. ⁽²⁾ The implication that current spending levels are sufficient to meet the global needs for water highlights a significant distortion between the acknowledged water crisis and an understanding of what is required to address it. Not only does the report’s conclusion overlook the current lack of universal coverage despite current financing levels; it also fails to account for population growth and the aging water and sanitation infrastructure systems that will need to be replaced between now and 2015, or 2025. It also fails to take account of the need for sanitation measures to accompany basic water supply, which are often not part of current spending plans (as footnote 9 to the Financing Water For All: Report of the World Panel on Water Infrastructure, points out). Finally, it fails to take into account funding for IWRM, a critical aspect of sustainable water resource management. Consequently, this is a much smaller amount than that needed to meet the less ambitious MDGs for water and sanitation – i.e. the EUWI targets

(1) GWP. 2000. “Towards Water Security: A Framework for Action.” Relevant pages are p. 75 and Annex.

(2) Recommendations of the High-level Panel on Financing for Development, 26 June 2001, p. 69. Those recommendations refer to figures by the Global Water Partnership and the Water and Sanitation Collaborative Council.

2.2.4 *How much extra finance is needed to meet IWRM targets?*

The Framework for Action paper provides a “back of the envelope” estimation of costs for municipal wastewater treatment, industrial effluent, agriculture, and environmental protection, as seen in *Table 2.1*. These estimates are approximate ⁽¹⁾and include about 15% of total cost for operations and maintenance, although it is recognised that O&M costs will vary widely.

Table 2.1 *Indicative costs of providing IWRM-related water services in developing countries, 2000 and per year to achieve Vision 21*

	Estimated current cost, 2000 (in USD bn)	Annual cost required, 2000-2025 (in USD bn)
Municipal Waste Water Treatment	14	70
Industrial Effluent	7	30
Agriculture	32.5	40
Environmental Protection	7.5	10
<i>Total</i>	<i>61</i>	<i>150</i>

It is difficult to transfer these Vision 21 estimates to the IWRM targets of the MDGs or of the EUWI, as both their definitions and their timelines do not match those of the MDGs or the EUWI. Consequently, they are not included in the estimate of the financial challenge facing the EUWI.

2.2.5 *Summary*

In addition to what is currently being spent, a best guess zone for the financial challenge facing the EUWI ranges from a further USD 9 billion/year to meet the MDGs (World Bank 2002), up to USD 30 billion/year, to achieve water supply and sanitation for all by 2025 (GWP, 2000). Much of this is for sanitation needs. A best guess for IWRM has not been possible and it is important to realise that the figure of an extra USD9-30 billion per year, does not therefore include an IWRM component.

(1) For the estimates on wastewater treatment, Vision 21 assumed that 10% of effluent is treated before it is discharged to water bodies at present; the Vision scenario is based on 20% wastewater treatment as a target for 2025. There is even less data about industrial effluent, and the costs and coverage are assumed to be half that of municipal type waste. Costs on agricultural development were very tentative, noting that considerably more investment will be required to drain and reclaim degraded land and on upgrading and modernising systems to more water efficient methods. (Source: Framework for Action, Annex III. Internet: <http://www.gwpforum.org/gwp/library/sec4.pdf>. Pages 104-107.)

2.3 *HOW MUCH FINANCING IS CURRENTLY PROVIDED, BY WHOM AND WHERE?*

2.3.1 *Introduction*

This section assesses how much has historically been spent in the water sector by whom and where. The assumption is that if past and current levels of finance could be better understood, it may be easier to determine future funding allocations (in line with the EUWI goals) through improved coordination of sources and tighter targeting of finance on those countries, regions or sectors most in need.

The following issues are looked at in turn:

- Relative to each other, how much finance is provided by aid, the private sector and the domestic public sector (via tax and user charges) to water and sanitation in developing countries?
- How much finance does the EU aid family provide?
- How much finance does the private sector provide?
- How much finance does the domestic public sector provide?
- Where and how big are the gaps?

Additional information on data availability is provided in the Annexes. Using sub-Saharan Africa as a case study, *Annex B* provides practical guidance to regional components that would seek to carry out this kind of analysis in order to focus the potential contribution of the EUWI within their relevant region. *Annex C* provides guidance on how to look at potential sources of data for assessing past and current financing flows at a more detailed level.

2.3.2 *Overall financing*

Substantial amounts of funding are currently invested in the water sector worldwide, although sanitation receives a relatively low share. The majority of finance is provided domestically, but Africa is most reliant on external support.

A comprehensive study undertaken by WHO and UNICEF examined coverage of water and sanitation services and current funding in developing countries. ⁽¹⁾It calculated average investments in Africa, Asia and Latin America and the Caribbean over the period 1990-2000 coming from two main sources: government agencies (national) and external support agencies. On average, those sources contributed USD 16 billion per year to water and sanitation, although only one-fifth was directed towards sanitation. ⁽²⁾ Of the

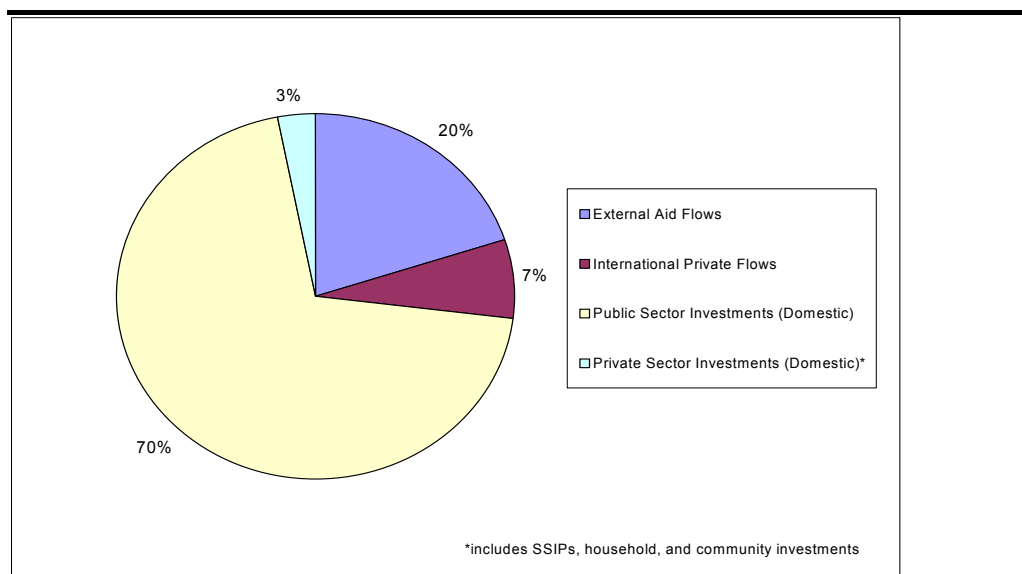
(1) WHO and UNICEF, "Global Water Supply and Sanitation Assessment 2000 Report." 2000.

(2) NOTE that investments by households are not included in those figures and that investment in sanitation may be difficult to identify with precision as many development projects are a combination of water and sanitation investments.

total, 58 percent came from national government agencies and the rest from external support agencies. In Africa, the contribution from external support agencies was the highest, at 68 percent.

An additional study by WaterAid estimated current global spending on water and sanitation in the region of USD 30 billion, with the majority being provided by the domestic public sector, as shown in *Figure 2.1* below. ⁽¹⁾

Figure 2.1 Breakdown of current financing to the water sector



Source: Shailaja Annamradju, Belinda Calaguas and Eric Gutierrez. 2002. "Financing water and sanitation". WaterAid, UK. P.8. Internet: <http://www.wateraid.org.uk/pdf/financingfinaldraft.pdf>

2.3.3 Finance from the EU aid family

Summary

Overall, development assistance flows from the EU to the water sector are on the decline. Even if the Monterrey commitments are fully met, they will provide less than a tenth of the lower bound estimate of the extra finance required to meet the water sector MDGs. The move toward non-sectoral financing of Poverty Reduction Strategies may cause further challenges.

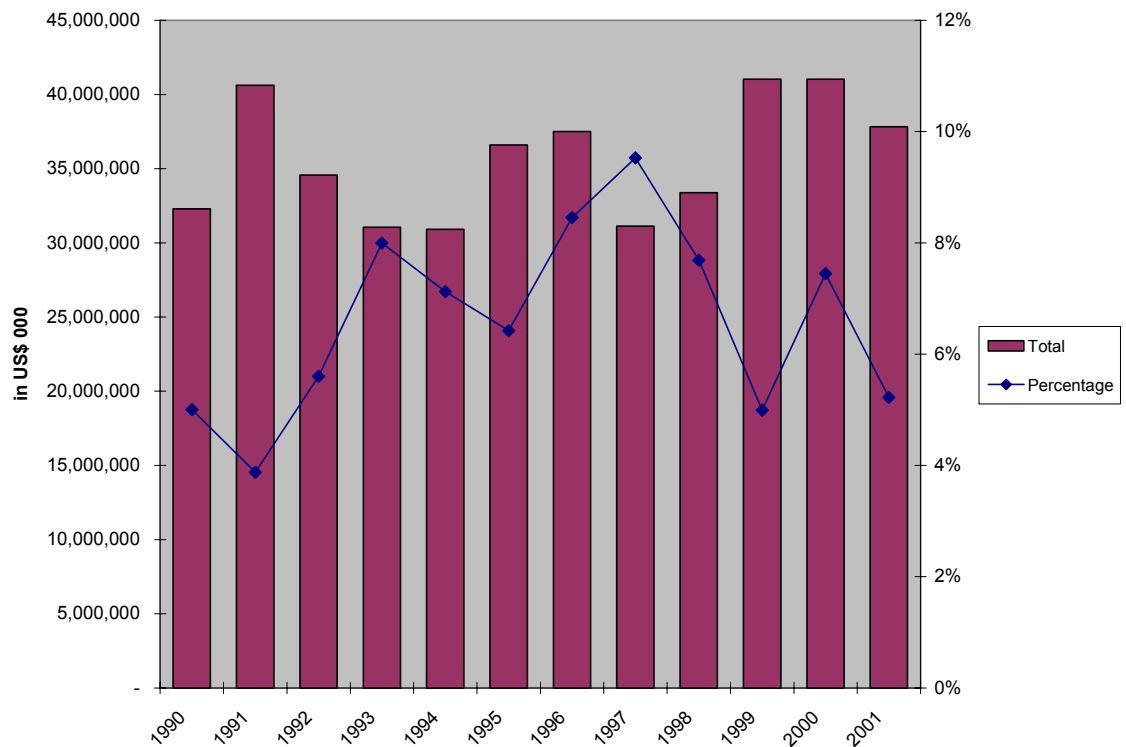
General Trends

Official Development Assistance (ODA) can be broadly defined as grants and loans provided by developed countries to developing countries (a more specific definition and a detailed explanation of how these flows are estimated and tracked is presented in *Annex B*).

(1) Shailaja Annamradju, Belinda Calaguas and Eric Gutierrez, "Financing water and sanitation." <http://www.wateraid.org.uk/pdf/financingfinaldraft.pdf>.

The general trend in the volume of EU official development assistance relative to economic growth in industrialised countries and population growth in developing countries is one of decline. Aid to the water sector is also on the decline, both globally and from the EU. Despite a spike in the percentage allocated to the water sector in 2000, the average percentage of ODA allocated to the water sector out of total bilateral ODA from the EU remains under 5 percent (see *Figure 2.2* below). For all OECD/ DAC countries combined this percentage is slightly higher (6.6 percent). It has been increasing steadily since 1986 when it stood at 3.4 percent.

Figure 2.2 *Bilateral ODA/ OA commitments from the EU Member States and the EC and the share of commitments to the Water Sector as part of this total, 1990-2001*

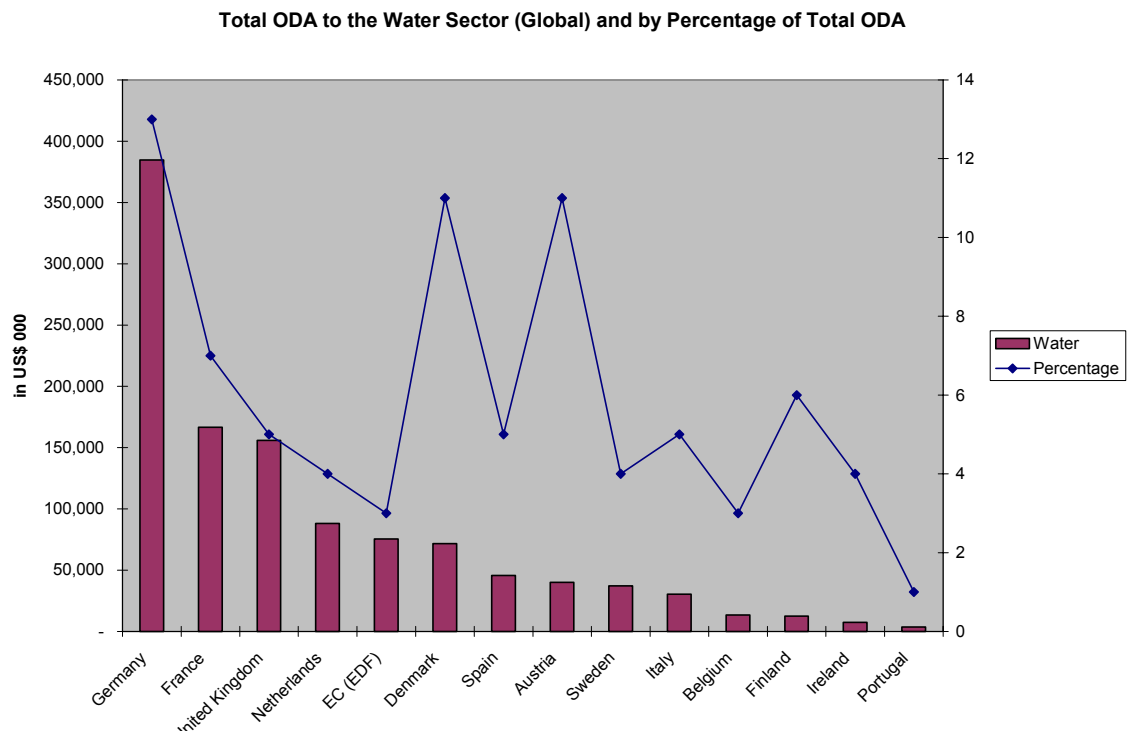


Source: OECD CRS Database, 2003. Data were obtained by running a query on commitments (aggregated by sector) from EU member States and the EC (EDF and EIB) for years 1990-2001.

Between 1997-2001, EU Member States allocated on average a total of USD 1.06 billion per year to water and sanitation projects via their bilateral ODA programmes (see *Figure 2.3*). The EC contributed a further average of USD 75 million per year, although this figure accounts only for funding through the EIB and EDF. (This tends to introduce a bias towards ACP countries, as flows to the EECCA or other non-ACP regions are not currently covered in the EC reporting to the OECD-CRS database).

Figure 2.3 shows that the European Union and its Member States do make a significant contribution to water and sanitation via their ODA programmes. EU Member States treat the water sector with varying degrees of priority, however. Germany grants the highest degree priority by allocating 10 percent of its bilateral ODA to the water sector, while the EC gives the least priority to the water sector in its multilateral programmes, in percentage terms.

Figure 2.3 *ODA to the Water Sector and its share in total bilateral ODA by EU Member State, 5-year averages, 1997-2001*



Source: OECD CRS Database, 2003.

Monterrey Agreement to Increase Aid

In terms of increasing the overall amount of aid, there have been some important initiatives, notably the Monterrey Agreement (see Box 2.4 below). The Monterrey Agreement, whereby the EU pledged to increase aid from an average 0.33% of GNI to 0.39% of GNI should bring an additional USD 16 billion per year by 2006. If all EU countries were to allocate 0.7% of GNI to ODA, an additional USD 48 billion per year could become available. ⁽¹⁾

(1) Note that Denmark's ODA is at present at 1 % of GNI and no increase is foreseen. The Danish government is committed to keep the current level of ODA. This implies that future ODA could be less than 1 % of GNI, but never less than 0.7 %. Similarly, the Netherlands are not planning to increase their commitment as they are already complying with the norm.

However, the projected increases in development assistance via the Monterrey Agreement alone will not necessarily flow to the water sector and will not be sufficient to meet the financing gap. If overall the EU aid family continue to allocate 5 percent (or less) to the water sector, and if the Monterrey commitments of increasing GNI to 0.39% are fully met, this will provide USD0.8 billion extra per year for the sector from the EU aid family - less than a tenth of the lower bound estimate (USD 9 billion) of the extra finance required to meet the water sector MDGs.

Hence, the additional funds from Monterrey can make a significant contribution to meeting the MDGs, but only if the water sector as a whole is treated as a key priority and only if those funds are spent more efficiently, with the objective of leveraging other forms of finance, including from users and from the private sector.

Box2.4

The Monterrey Agreement

The Monterrey Agreement came about as the culmination of the UN Financing for Development Conference held in Monterrey in March 2002. It was signed by leaders from developed and developing countries, and aims to address the “challenges of financing for development around the world”. The Agreement acknowledges that a stable domestic environment is required for both fiscal responsibility and growth, along with democracy and sound economic policy. Notably, corruption is addressed as a hindrance to development. The Agreement then details ways in which this stable environment can be achieved, while emphasising the self-determination of each country.

Key features relevant to the EU Water Initiative are:

- Additional funds can be “unlocked” through policy, regulatory and structural reforms as a major source of future funding for development;
- Trade is a key component for development and global economic stability;
- ODA should complement other financing tools, especially in countries least able to attract private direct investment;
- Existing initiatives should be strengthened to reduce the debt burden of HIPCs, in order to free up additional funds for infrastructure and social services;
- Developed countries are “urged” to increase ODA to the target level of 0.7 percent of GNP to developing countries, with 0.15-0.20 percent of GNP from developed countries to least developed countries.

The Monterrey Agreement does not specifically address the water sector; however, it does provide a good framework for understanding the mechanisms through which water sector financing can be approached. No new money is targeted through this Agreement. Instead, existing ODA and additional financing capacity through debt relief to HIPCs is to be used to leverage additional financing for development from the private sector. Likewise, it is projected that through improved governance, an enabling environment for PSP can be fostered both for small and medium-sized enterprises and multi-national enterprises.

Trend towards funding general poverty reduction strategies, not sectors

A further challenge with respect to EU aid and the water sector is presented by the multi-donor focus on providing direct finance for Poverty Reduction Strategies.

On the one hand, this could be an opportunity. The bulk of EU assistance is currently provided via bilateral grants, with limited coordination between Member States for defining priorities and identification of gaps. Hence, the move towards performance-based financing instruments, with better incentives for governance, and to budgetary support particularly in the context of Poverty Reduction Strategy Papers (PRSPs) might provide opportunities for better co-ordination.

However, on the other hand, PRSPs in Africa are currently failing to give priority to water resources, water supply and sanitation services. Even though water investments are perceived as basic needs at the grassroots level, they often do not figure prominently in priority investment plans and PRSPs. ODA funding for the sector will be less as a result.

In 2002, the Water and Sanitation Program (WSP) undertook a study of water supply and sanitation in the PRSP process. It found that initiatives for water within PRSPs were lacking in general, with even less consideration for water service improvements specifically for the poor. Further, initiatives addressing sanitation are largely absent. ⁽¹⁾

This is in stark contrast with research conducted by the World Bank, which found that the water and sanitation sector is the most likely (with a score of 100 out of an index of 100) to achieve improvements in poverty reduction, when placed within the logical framework of the PRSP process (see *Table 2.5*).

Table 2.5 Sectors Most prevalent in PRSP Logical Framework

Water Sectors	
Water and sanitation (INDEX = 100)	100
Private sector growth and investment climate	85
Transport	79
ICT	74
Energy	69
Urban	40
Micro-finance	38
Small and medium sized enterprises	31

Source: http://www.worldbank.org/energy/energyweek/2002/gov_fclottes.pdf

This “under-prioritisation” is partly due to the fact that many governments, when drawing up their PRSP plans, rely on the continuation of significant

(1) “Water Supply and Sanitation in PRSP Initiatives – A Desk Review of Emerging Experience in Sub-Saharan Africa (SSA).” 2002. WSP, Nairobi.

levels of donor support for their water and sanitation sectors, via bilateral programmes falling outside of the PRSP process. This may be due to the way in which the water and sanitation sector is organised at the country level, where water and sanitation lack institutional weight and presence compared with other sectors, and at sector level, where monitoring and evaluation systems are often weak.

Combined with a lack of regional and national coordination in financing for the water sector (across donor, public and private sectors), this could be creating a situation where the prioritisation for investments in the water sector falters when the PRSP document is assembled. Other sectors, such as health and education may be seen as “more difficult” to secure resources for, and, as a result, they move up the PRSP priority list. Consequently, there is a danger that the status quo of many, uncoordinated and possibly redundant water sector projects, programmes and initiatives may continue and, worryingly, that they will increasingly lie outside of the mainstream PRSP – and therefore integrated development priorities.

2.3.4 *Private financing*

Private sector finance ⁽¹⁾ has often been cited as a potentially large source of funding for the water sector, especially for water and sanitation services. At present, however, the private sector accounts at best for five percent of all water services provided globally. ⁽²⁾

International Private Sector

Through the 1990s, encouraging a larger role for the international private sector was considered to be the way forward for improving the water sector in developing countries. Primarily through concession models, private companies (generally international private utilities) assumed management and operation of waterworks, and also assumed responsibility for capital expenditures over a given period of time (generally 15-25 years). Under such models, the public sector retained ownership. During the early 1990s, companies such as Suez (now Ondo), Vivendi (now Veolia), RWE, and Thames (now a subsidiary of RWE) were able to finance these expansions via strong balance sheets, which provided access to favourable lending conditions in the major debt markets (through the issuing of bonds).

Another, way for the international private sector to be involved in the overseas water sector is through providing equity investment to water utilities or private water companies in developing countries. For example, to avoid

(1) Private sector finance for the water sector in this case considers commercial debt and equity financing for infrastructure.

(2) Private sector participation in IWRM is even less developed given the "public good" nature of such activities, although private companies are increasingly interested in providing services in this area.

currency risk, a larger private utility could purchase shares in a profitable water utility or private water company in a developing country. In so doing, the local partner would have access to the support of the larger company. This pattern became more common in the late 1990's, when the bulk of financing for the international water sector was through debt.

Consequently during the 1990's the flow of finance from the international private sector into water companies in developing countries evolved from debt financed expansion (concessions) to that of equity investments (buying shares).

At the turn of the 21st century however, most of these larger companies are now pursuing strong debt reduction strategies. These strategies include selling off acquisitions that were considered key just years before and backing out of unprofitable concession deals. Instead, in what has seemed a sluggish international market, there are signs that smaller, regional private sector companies are bidding for private sector projects, and are perhaps more able to accommodate the unique project risks – such as political and currency risks – that face the sector.

Box 2.6

The Informal Domestic Private Sector is Important too.

Given the current investment climate, an important trend is the increased attention being paid to the role of domestic private sector providers in the water and sanitation sector, and to user-based finance. For example, with respect to the domestic private sector, increasing attention is turning towards the role of migrant remittances, especially for investment in rural areas. ⁽¹⁾ Small and medium scale providers have also demonstrated a keen ability to provide services to the poor within and beyond existing networked areas. These providers operate in formal and informal markets, and are largely unregulated. They could make a substantial contribution to the sector.

However, no data was available to this study on the current contribution of the domestic private sector to the financing of the water sector in developing countries.

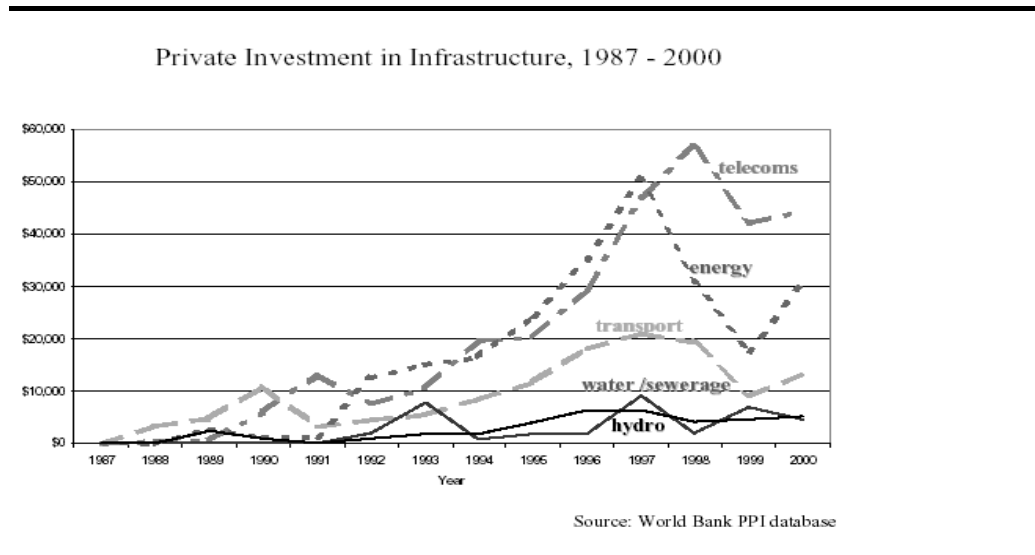
The most comprehensive data on private sector flows into infrastructure projects are tracked by the PPI database managed by the World Bank. This database tracks the amount of investments committed by the private sector as part of infrastructure deals, but does not capture equity investments or other financial mechanisms used by the private sector, such as for risk mitigation. Nevertheless, this is the best publicly available reference source for international private sector infrastructure flows, including water. ⁽²⁾

(1) For further information, see the work carried out by PsEau in West Africa in this respect, with the setting up of networks to help technology transfers to rural Africa through existing migrant networks. See <http://www.pseau.org/pmie/index.htm>.

(2) This database captures contract and investment information for infrastructure projects, newly opened or managed by private companies. However, this database does not necessarily capture all flows, as discussed further in Annex B. The OECD DAC database tracks other types of private flows but this information is not available publicly.

Figure 2.4 shows private capital flows to infrastructure globally based on data from the PPI database. As seen, despite the activities by international utilities in the 1990's, the water sector has received historically just a fraction of total infrastructure investments worldwide and this share has been stable or declining in recent.

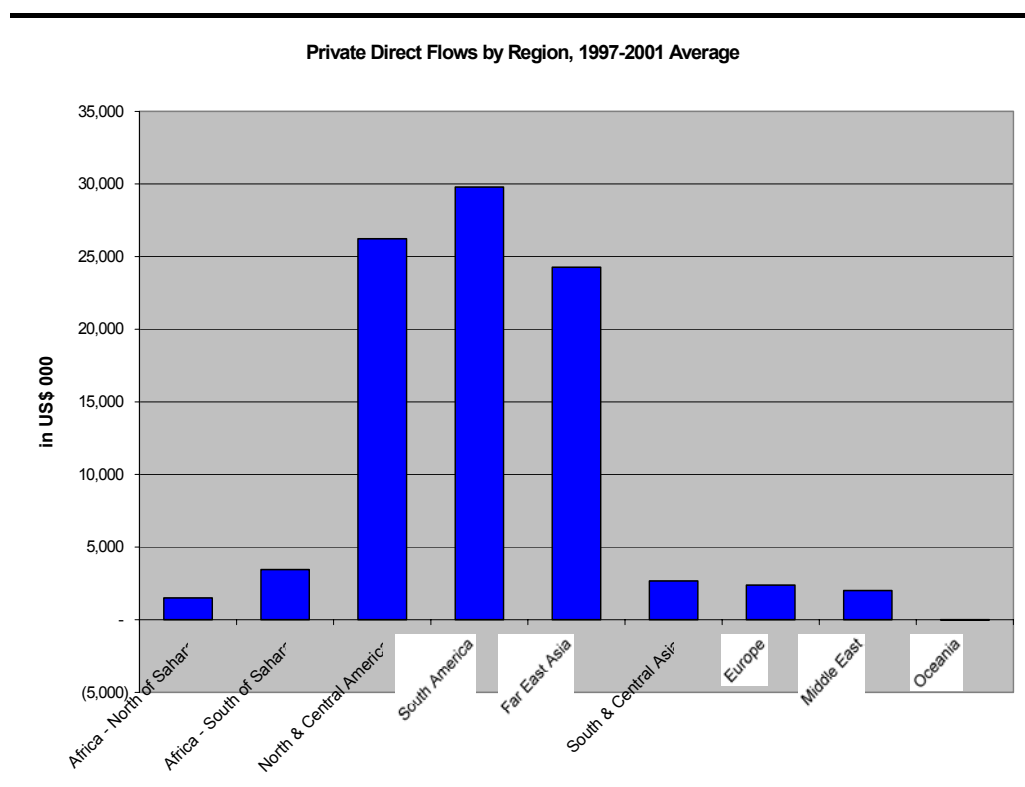
Figure 2.4 *Private Investment in Infrastructure, 1987-2000, USD billion*



Source: World Bank PPI database

Figure 2.5 below shows the average private direct investment between 1997-2000 based on the region receiving those flows. A clear regional bias can be seen.

Figure 2.5 *Private Direct Investment from DAC Countries, 1997-2001*



Source: OECD DAC Database, 2003.

Figure 2.5 shows how private capital flows to the water sector from 1997-2001 were directed in particular to Latin America and South-East Asia. This is because these regions were considered more stable in political and macro-economic terms than Africa and the Middle East. In Latin America and South East Asia local capital markets and regulatory systems have also been established, to facilitate private sector participation. However, instability has also affected those regions recently, especially with regards to macro-economic downturns impacting flagship concessions, such as those in Manila and Buenos Aires, leading to a much more cautious attitude by private investors.

It is therefore highly unlikely that, in the absence of increased funding from domestic sources and/or more effectively used external aid, large-scale private financing will be a panacea for either the challenges facing poorer regions of the world, such as Africa, or the economically unstable parts of the world such as Latin America and South East Asia.

2.3.5 *Public financing*

From a global perspective, the domestic public sector in developing countries provides the large majority of financing for the water sector, especially in

South Asia and Latin America. But it needs to be better directed toward the poor.

The scale to which the domestic public sector (comprising of finance derived from domestic tax revenue or user charges for water services) must be relied on to provide access to water supply and sanitation finance (both for investment and for recurrent financing needs) cannot be understated.

However, in relation to the MDGs, governments in developing countries have been found to spend just a fraction of their annual budgets for the water sector on *low-cost* water and sanitation services (for the poorest), although this percentage can vary widely from one country or one region to another. Public spending on basic water and sanitation needs in Africa is particularly low as Box 2.7. below shows.

Box 2.7 ***Comparing Public Sector Spending on Basic Water and Sanitation Needs in Developing Countries:***

The level of public sector finance spent on meeting basic (low-cost) water and sanitation infrastructure needs has been estimated at, on average, 1-3 percent of country-level annual budgets, although there is a wide variance depending on the region of the world. This is important for the EU Water Initiative, as the dependence on aid flows is somewhat related to the capacity of local governments to plan and implement their own policies for meeting the water and sanitation related MDGs, and to finance their own infrastructure with minimal external assistance.

African countries spend proportionally less on basic water and sanitation needs than the global average, averaging spending of about 1 percent of annual budgets or less, with the share for sanitation low or non-existent. ⁽¹⁾ Possible reasons for this include:

- An abundance of external donors and initiatives that compete to provide low-cost water services, and that operate in a weak institutional environment;
- Other pressing needs, including health and education and competing demands over limited resources;
- Heavy debt loads: some African governments spend up to 60% of their national budget on foreign debt service payments.

Within these figures, it is important to differentiate between recurrent and capital (development) expenditure for the water and sanitation sector, and to note that most public sector funding is going toward investment rather than recurring costs. Further, while contributions from Africa's public sector are low relative to the global average, a large percentage of funding for the sector is also channelled through NGOs. ⁽²⁾

However, while data on domestic public sector funding, as well as on user charges or community investments is usually available on a case-by-case basis at the country level (with varying degrees of accuracy), it is not aggregated

(1) Water Supply and Sanitation in PRSP Initiatives: A Desk Review of Emerging Experiences in Sub-Saharan Africa (SSA)." 2002. Water and Sanitation Programme. Nairobi, Kenya.

(2) The Water and Sanitation Programme - Africa is currently conducting a study of resource flows in Africa, and preliminary results indicate that NGO sector expenditures, relative to total expenditures for water and sanitation in the country, are quite high.

across countries, except in the event of limited surveys. ⁽¹⁾It is therefore notoriously unreliable and difficult to gather (see *Annex B*).

2.3.6 *Financing from the voluntary sector*

A final source of finance for the water and sanitation sector is that of NGO or other voluntary flows (such as remittances).

Data on international NGO funding is sometimes available on a case-by-case basis; however records of funding for local NGOs are nearly impossible to obtain. Therefore, it was unfortunately not possible to get a comprehensive view of the (potentially large) contribution that the NGO sector is making to water. Tracking the volume and use of remittances for water is also very difficult at the global level, despite the high value of remittances in total, and the reliance poorer households have in them in developing countries to help pay in cash for essential items, such as water services.

2.4 *WHERE AND HOW BIG ARE THE GAPS AND OVERLAPS IN THESE FINANCE FLOWS?*

The challenge facing the EUWI is to help provide an extra USD9 – 30 billion a year in finance to the water sector to meet its goals, without considering IRWM needs.

Aid flows, even if the Monterrey Agreements are fully met, will fall short by more than a factor of 10 on this lower bound estimate, unless a much stronger sectoral preference is given to water and sanitation. This is unlikely within the context of both the HIV crisis in developing countries and the move toward the provision of direct budgetary assistance via Poverty Reduction Strategies for poorer countries, which often do not have water and sanitation high on their list of priorities.

Annex B looks in detail at EU aid flows to sub-Saharan Africa, pointing out where gaps and overlaps lie. In essence, this case study shows that the bulk of water sector finance goes to (1) large-scale rather than explicitly poverty focused water sector schemes and (2) to those countries whose needs for improved access to water sanitation are less.

As things currently stand, the private sector will not have much impact either on the finance problem. Between 1997 and 2001, the private sector supplied just 5 percent of finance to the global water sector, and this was directed mainly into “less risky” regions such as large cities in Latin America and

(1) See for example the document quoted in the main report: "Water Supply and Sanitation in PRSP Initiatives. A Desk Review of Emerging Experiences in Sub-Saharan Africa", Water and Sanitation Programme, Nairobi, 2002 for data on domestic public sector spending in that region.

South East Asia, not to where the poorest are, in the smaller towns of the poorest countries, mostly in sub Saharan Africa. It seems that the hopes of the 1990's, for the private sector to be a wholly market-based panacea for the lack of finance in the water sector in developing countries, may be misplaced.

The domestic sector (providing finance via tax revenues and user charges) is the major purveyor of finance for the water sector in developing countries, apart from in Africa where there is nearly a 70 percent reliance on external (aid) funds. Yet, in general it seems most governments do not allocate much of their budgets toward pro-poor water and sanitation services, whether they rely on domestically raised funds or not.

Hence, and despite the lack of solid data, it is apparent that meeting the EUWI targets will require considerable financial efforts - "business-as-usual" is not likely to be sufficient: EU aid is not enough and often goes to the wrong places; domestic finance though important is not focused well enough on the poorest; and current private sector flows of finance are just too low, and historically have steered away from the riskier markets (particularly sub-Saharan Africa), where most of the poorest are.

The relationship between these three broad forms of finance seems important. What if aid from the EU family could be better used to decrease the risky nature of the water sector? Could much more private sector finance be leveraged in? If the EUWI focused on governance and other issues, could more private sector and domestic finance be accumulated in sub-Saharan African countries? Would this be a more efficient way of working to meet the EUWI targets - showing, for example, how a much-improved ratio of an aid euro to euros of domestic and private sector investment could be achieved than at present?

This seems a useful financing route for the EUWI to take. It reflects the EUWI goals of improving the harmony of the EU aid family's water sector spending; and to improve the leveraging of private sector finance into the sector.

Consequently, the next stage of the analysis is to examine what the other non-aid sources of finance might be; what stops or constrains them being attracted in greater volume to the water sector; and how the EU's aid programmes could be better used to ease these constraints.

3.1*INTRODUCTION*

The working assumption of the EUWI finance strategy is that adequate sources of non-aid finance do exist to help meet the water sector MDGs, but that the water sector in developing countries fails to attract and retain them. There must be some common constraints to financing the sector from sources other than WU aid alone.

Consequently, rather than lobbying for simply more water sector EU aid, might it be the case that existing aid commitments could be used more effectively if they were targeted instead toward alleviating the constraints that stop these other sources of finance becoming available for investment in the water sector? In this way EU aid could therefore help to leverage a greater amount (and mixture) of other sorts of finance into the sector. This is consistent with the goals of the EUWI finance component and would ultimately help meet the EUWI targets.

The objective of this section is therefore to:

- Explore the wider range of non-aid finance sources that may be available to a regional water sector;
- To identify some common constraints that stop them being used more fully; and
- To suggest some ways in which EU aid may be better targeted to overcome these constraints, thus acting as a lever to attract more of this finance.

Importantly, in using EU aid to overcome these constraints, this section also highlights where there may be existing initiatives for the regional finance components to build upon.

To meet the objectives of the section, two questions are addressed.

1. What are the key constraints, which prevent the gaps in finance described in Section 2 from being filled?
2. How can these constraints be alleviated, so as to lever more finance into the water sector?

Annexes D and E support this section. While, the case study process focuses on sub-Saharan Africa, it is hoped that the general approach taken for

investigating constraints to finance and ways of mitigating them, can be of wider use to the regional components of the EUWI in their finance investigations.

3.2 SOURCES OF FINANCE

It is important to recognise that the range of EU financing sources and mechanisms potentially available for increasing investment in the water sector in developing countries, incorporates more than just overseas aid grants for water projects alone.

For example, there are several different ways of providing aid money to help develop infrastructure; there are a number of aid mechanisms designed to lever more money from the private sector into developing countries; use is a range of ways in which finance can be obtained from the domestic population or water users; and there is also a range of finance sources potentially available from the national and international private sectors.

The following text box attempts to list the “menu” of sources and mechanisms for financing for the water sector, which could potentially be exploited more so than at present to meet the financing challenge. (Grant-based overseas aid is included as one type of grant).

Box 3.1 *Finding more finance for the water sector: sources and mechanisms*

- | | |
|--|---|
| <ul style="list-style-type: none"> • From water users or the domestic population (via tariffs, taxes and subsidies, and environmental charges) • Grants • Loans • Mixed Credits and Export Funds | <ul style="list-style-type: none"> • Bond Markets • Equity Stakes • Direct Private Investment • PPP/ PFI Initiatives • Voluntary Finance Schemes |
|--|---|

There are also a number of different ways for donors to provide their grants to water sector projects, such as through the use of micro-finance or output based aid approaches, sector wide approaches and sectoral funds.

Output Based Aid (OBA)
 Under OBA schemes, overseas aid to private firms, NGOs, or the public sector is linked to clearly defined performance indicators. Thus, as development practices shift towards more demand-responsive development approaches, output-based aid provides a practical way to monitor and evaluate the progress and effectiveness of aid funding over time.

An output-based strategy for water can be applied to subsidies and tariffs, contracts, and programs, for example through the PRSP process. As part of the process, donors and recipients need to establish the role of funding, clarify the responsibilities of all parties, define

performance, determine how the scheme will be administered, and link payment to performance.

The more widespread use of OBA principles linked to grant funds may raise the profile of cost recovery and other targets for sustainability in the water sector, along with promoting accountability in both systems and financial management.

Currently, the World Bank and DFID are interested in developing OBA approaches.

Annex D provides a detailed explanation about each of these sources and mechanisms of providing finance.

3.3 *CONSTRAINTS TO FINANCE*

Nevertheless, despite this range of finance sources and mechanisms, there is currently a large gap between the amount of finance being provided and that which is required to meet the EUWI's goals. It is clear that these sources and mechanisms are not being used to their full potential. Current levels of both private sector finance and domestic finance are particularly low, in general, relative to the challenge.

The analysis sought to identify a range of obstacles or constraints to financing the water sector, from finance sources other than aid alone. The aim was to pin point some common groups or types of constraint. The identification process was undertaken with help from the Working Group, but it also drew upon key reference points from the report of the World Panel on Financing for Water Infrastructure.

Box 3.2 *The "Roots of the Problem" According to the World Panel on Financing Water Infrastructure*

Roots of the Problem

The Panel's final report contains a section entitled "The Roots of the Problem" (section 3 pp 9-11). It is here where constraints to the attraction of more private sector finance into the water sector are explored. Broadly the Panel identified the following range of issues as important constraints

- Apparent low priority given to water sector by central government
- Political interference
- Poor management structure and imprecise objectives of water undertakings
- Inadequate general legal framework
- Lack of transparency in award of contracts
- Weak and inexperienced regulators
- Resistance to cost recovering tariffs
- Foreign exchange risks
- Sub sovereign risks
- Political and regulatory risks
- Contractual risks

- | |
|---|
| <ul style="list-style-type: none">• Risks of low sector rate of return• Risks related to capital intensity of projects |
|---|

Each of these issues identified by the Panel is a complex issue. Many of them are captured in detail in the Panel's report and were also discussed by the EUWI Finance Working Group.

However, in order to be as practical as possible, it was important to group this range of complex issues (and others, which the working group thought were also important) into manageable blocks, containing similar types of constraint or similar sets of problems.

The Finance Component consequently identified four groups of common constraints.

- Commercial Risks
- Political Risk and Governance Issues
- A Lack of Good Projects
- A Lack of National Capacity

Each groups is expanded upon below.

3.3.1 *Commercial Risks*

Commercial risks may include:

- *Foreign exchange risk* – revenues from water projects tend to be generated in local currencies, which poses a risk to external investment because of exposure to foreign currency fluctuations. This risk can be coupled with other financial risks during periods of macro-economic instability. Foreign exchange risk can be mitigated through the raising of local currency funds wherever possible. However, there is often a dramatic lack of local investors and the local capital markets are often underdeveloped.
- *Contractual risk* – water sector contracts tend to have a long life which, when combined with a lack of uncertainty, ⁽¹⁾can bind operators into providing a service in a changing operating environment, exposing them to a greater degree of risk. In any investment, therefore, the timeframe is critical and a thorough country analysis must be performed

(1) e.g. uncertainty in assessing viability of capital investment programs at a time when future revenue prospects from such programs are not transparent.

up-front, notably in view of defining the clauses for eventual contract renegotiations.

- *Risks in operating water and sanitation businesses;* for instance in introducing efficiencies in billing systems and tariff collection or reducing water losses from leakage or theft. These types of risk are usually readily accepted by the private sector;
- *Risks in undertaking capital investment programmes* for water or sewerage trunk mains and reticulation systems. The commercial risks here are relatively low, because exposure to uncertain sub-soil risk means it is usually impractical to require fixed price contracting.
- *Risks in constructing water or sewage treatment plants.* Here lump sum fixed price contracts are often used, hence the commercial risk can be managed perhaps via the use of output-based specifications.

In general, these kinds of commercial risks are normally acceptable to the private sector. Commercial risk can be mitigated by negotiating well, maximising levels of debt leverage and through the use of risk guarantees.

Private sector operators often require a guarantee on their investments to address the variety of commercial risks associated with operating in developing countries. Often, these risk guarantees are likely to be backed by international institutions, and sometimes partially by Sovereign governments if the institutional environment is strong enough.

Risk guarantees act as a form of insurance for loans associated with financing infrastructure projects. They serve to neutralise country risk, and can be used for more favourable lending terms. A recent recommendation for a major form of commercial risk guarantee was presented in the Final Report of the World Panel on Financing Water Infrastructure. The report recognised foreign exchange rate risks as a major constraint to attracting more financing into the water sector. It recommended a Backstopping Liquidity Fund to help protect the private sector against such currency fluctuations. Such a fund would help, in effect, to provide a guarantee against this risk.

However, another mechanism for risk guarantee is already in play and could be enhanced through the EUWI. This is the *Development Guarantee Company (GuarantCo)*, an initiative developed by the multi-donor Private Infrastructure Donor Group (see *Annex D*). GuarantCo provides partial risk guarantees for local currency bonds issued by municipalities and utility companies for infrastructure works, and to offer to put operations to local banks for loans to municipalities and utility companies for infrastructure works. Feasibility studies for GuarantCo were undertaken in mid-2002 and the company has recently been formed.

Within the water sector, however, the involvement of local and national governments as part of a financing consortium can often increase the perceived risk, due to the increased possibility that these governments might call in a bond or breach the contract depending on their political and financial situation. The same risk is valid for poorly or non-regulated markets.

Risk guarantees are useful tools to facilitate investments in areas where commercial project development might otherwise be unfeasible. However, it seems that a key risk perceived to be present by debt providers (the providers of finance) is often the *political risk*, rather than simply the commercial risk perceived by operators. Hence, as well as providing ways to minimise commercial risk, it may be more (or as) useful for EU donors to explore ways to minimise political risks to satisfy debt providers so that a private (or public) water firm can leverage enough affordable finance to undertake an improvement programme.

3.3.2

Political Risk

Debt providers are generally concerned at the *political and regulatory* risks to an operator's revenue forecasts. Interference by politicians and an unstable regulatory regime can alter market conditions and impact on water projects. These can be more important than the commercial risks which operators face and can mitigate against. These concerns tend to be associated with the potential political sensitivity of a water project, particularly at times of economic downturn when the following issues may become pertinent:

- Enforcing payment on defaulters by cutting off water supply;
- Securing regular tariff increases in practice, even if consistent with the relevant regulatory system or concession agreement;
- Obtaining permitted tariff increases to cover the effect of exposure to domestic currency depreciation from having long term debt denominated in foreign currency or any need to pay hard currency-linked dividends to equity invested by offshore shareholders; or
- Sub-sovereign risk – governments have been increasingly devolving responsibility for water services to sub-sovereign bodies, which do not, however, have equivalent powers to raise finance.

In addition, there may be uncertainty about the viability of capital investment programmes that may be required under a license or concession agreement, but which possess uncertain cost characteristics (or on the process of testing that viability with a regulator), at a time when future revenue prospects from the project are not clear.

Issues such as climatic variability (drought or climate change) may have specific impacts on water resources, and can add a perception of external risk to the project through their potential to affect project performance over the long term.

Interestingly, at the time of writing, the PIDG are also investigating the setting up of a programme of political risk insurance.

3.3.3 *Issues of Governance*

Many of the issues associated with political risk are embedded within the wider context of a stable enabling environment or good governance for the water sector. An unstable policy environment or a perception of opaque, undemocratic governance can be a constraint to attracting the finance required for the water sector to improve. Specifically, a lack of maturity in the policy environment for water in the recipient country (with regards to legislation, regulation, institutional framework, level of decentralisation, political commitment to tariff reform for example) is seen as a key constraint.

A poor governance environment for water can lead to the following:

- A lack of availability of favourable long-term debt conditions and mechanisms necessary for the long-term investments required for water related projects, due to policy or regulatory uncertainties;
- A difficulty in mobilising local currency guarantees due to high levels of currency uncertainty;
- Lack of trust in the long term political desire or will to adjust water sector policies or tariffs;
- Lack of commercial independence for national water sector operators or regulatory bodies;
- A lack of institutional and regulatory harmonisation resulting in different ministries with different, and sometimes conflicting, responsibilities for water.

What does a good governance environment look like for the water sector?

Annex E provides some general guidelines as to what “good governance” in the water sector could look like. It can be used as a start or reference point from which a recipient country can assess to what extent its political environment is as amenable as possible to the finance available for investment in the water sector. The guidelines provide some good governance ideas for facilitating:

- The role of public authorities;
- The contribution of civil society;

- The contribution of water operators and other service providers; and
- The contribution of financial institutions.

It is important to stress that *Annex E* provides guidance information only, and should not be read as a one-size-fits all blueprint for good water governance, nor as some form of conditionality tool, without which finance for water will not be forthcoming. It simply provides some guidelines.

There are also, however, some wider governance issues which present trans-national challenges. For example:

- Trans-boundary issues are particularly relevant to water projects because of the need to coordinate efforts in multiple regions. Conflicts over water allocation or problems of pollution across river basins may add further risk to successful policy implementation or project delivery.
- For irrigation projects especially, there is the problem of wider water subsidies existing in the EU. How will it be possible for the EU family to promote good governance and efficient pricing policies in recipient countries within this wider context of policy non-harmonisation?
- There can often be great difficulty in ensuring that all members of the EU family agree with the same broad objectives and principles of action for aid for the water sector. A lack of coordination or harmonisation in project designs, levels of subsidy and types of finance on offer can create missed messages and cause inefficiencies in policy delivery. Lack of coordination also absorbs scarce resources, which could be spent more effectively. These issues create governance challenges within the EU for improving aid delivery to the water sector.

3.3.4 *A Lack of Good Projects*

A common complaint from EU donors was that there is a lack of well-designed projects or programmes in the water sector for them to fund. This may be due to:

- The high up front costs of project preparation.
- The perception of investment in the water sector as a short-term goal instead of being a tool to ensure the long-term provision of cost effective and affordable services to different type of users. Too often water sector projects are designed by recipient countries as “prestige” capital investment show pieces (a large dam and reservoir, or the rehabilitation of

a major city's water supply and network and treatment plant, for example), with less attention paid in the design to the longer term commercial or financial sustainability of the investment than to the up front capital required.

- The large differences in policy, design, financing requirements and issues of risk that face the next generation of poverty-reducing water projects that are required in rural or peri-urban rather than urban areas or small rather than big towns, which are not being adequately addressed at present in the project design process.

On this last point, it is often difficult in the project design process to identify at what level the local counterpart for the smaller water project should be based – national, regional or local – for different types of project. For a small town project, a local level counterpart (municipal water authority) may be too small an entity to be able to provide satisfactory sub-sovereign guarantees. A counterpart at the regional level, however, can create the possibility of aggregating a number of smaller town projects together. Given the high cost of mobilising private and public resources, the regional scale counterpart maybe the more appropriate level for water projects focusing on smaller towns. However, the multi-disciplinary expertise and experience to design such “aggregation” projects - to bring multiple local stakeholders together to agree on project design and their own commitments and which contain commercially viable components, is often extremely difficult to find or mobilise within country.

In rural or peri-urban areas, there is also a challenge in designing affordable, demand-driven projects for the poor – these tend to be very local, small scale and communally owned schemes which don't offer an obvious potential for either scaling up into a larger programme, or for returns on external financing. Careful thought on policy design must be given to issues of cross subsidisation, innovative payment mechanisms and/or local credit facilities for these poorer customers.

Furthermore, to attract wider sources of finance to these projects, the commercial viability of a project's design must be assured from the inception by means of a number of clauses, which foresee the possible events that would off-balance the established return on the investment and the initial risk assessment. Such clauses should allow the periodic renegotiation of the price and performance conditions of the project as well as the redefinition of the project framework.

In short, to meet the EUWI targets for water and sanitation, the design of robust projects and programmes in non-municipal areas, that can also attract wider sources of finance, is a key constraint. A number of project preparation

initiatives and proposals have been developed to help mitigate these constraints, however, and could be refined further. These include:

- The Project Preparation Committee;
- The Infrastructure Development Company; and specific to Africa,
- The African Water Facility.

The Project Preparation Committee (PPC)

The Project Preparation Committee (PPC) is a networking mechanism established in 1993 to improve coordination and cooperation between IFIs, donors and countries in transition to facilitate environment related investments in CEE and the NIS. The PPC Secretariat is based in London at the EBRD, with officers designated to implement the PPC mandate located at the EBRD and the World Bank.

The PPC works by trying to 'match' donor grant funds for investment support or technical assistance to potential IFI loan finance for environmental projects, which have been given priority in this region and which fit the priorities of the EAP. Hence, the PPC is not a fund, a clearinghouse or a mechanism to evaluate projects. It deals only with projects co-financed by donors *and* IFIs, and does not deal with projects of a national or bilateral nature.

Project proposals are submitted by the National Government through normal channels to the IFIs or the bilateral donor. After the Central and Eastern European partner and the donor or bank have agreed on the contents of the project and the co-financing needed, the project can be presented to the PPC by one of the donors or IFIs that constitute the PPC.

PPC donors contribute to the PPC in several ways. For example, they provide:

- Grant aid to the countries of central and Eastern Europe and the NIS in preparing projects before they are submitted to the IFIs for consideration;
- Support for technical assistance aimed at institutional strengthening and policy development, a prerequisite for the implementation of sound investment projects;
- Support for technical assistance for projects on which IFIs are working. This can be done by specific PPC 'trust funds' established at the IFIs (e.g. by Japan, the Netherlands and by Switzerland), by specific contributions through bilateral assistance, or through other established mechanisms (such as general consultants 'trust funds');
- Co-financing for environmental investment projects. Donors can finance projects jointly or co-finance with IFI loans in the form of joint financing or parallel financing; and
- Funding for staff (PPC officers and PPC Secretariat) is primarily based at the EBRD and the World Bank.

Since its creation, the PPC has been effective at minimising the “revolving door” problem suffered by recipient country governments, when faced with a host of enthusiastic donors in the environmental sector. It has also allowed the finance available for environmental projects to be used more effectively, rather than necessarily leveraging in more money in total.

The EU water initiative could seek to build on the PPC for a better preparation and selection of projects and could seek to adapt this mechanism to other priority regions, particularly Africa.

Infrastructure Development Company

The *Infrastructure Development Company (DevCo)* is an initiative proposed by the multi-donor Private Infrastructure Donor Group (see *Annex D*). This would be a project preparation facility seeking to develop potential infrastructure projects to the point where they can be offered to private sector companies on a transparent, competitive basis. Implementation would be by the private sector alone or (commonly) working in partnership with other stakeholders in-country. Successful bids would be charged a levy to recover operating costs.

The African Water Facility

Supported initially and primarily by the Dutch Development Agency and with significant support from the African Development Bank, the African Water Facility (AWF) was conceived at a series of meetings and dialogues that have taken place over the last few years as a stepping-stone to meet the targets and goals for the water sector that were established by the African Water Vision and the Millennium Development Goals (MDGs). It was launched at the 3rd World Water Forum in Kyoto, March 2003. The AWF also aims to take advantage of the momentum that has been growing politically, through initiatives such as the New Partnership for Africa’s Development (NEPAD), the African Ministers Conference on Water (AMCOW), and the African Water Task Force (AWTF).

The primary objective of the AWF is to provide investment support for water resources management and water service provision in Africa. It aims to raise multi-donor and other funds to provide:

- A grant facility aimed at preparing projects and programmes and facilitating investment; and
- An investment facility to provide loans to finance strategic projects and programmes which would catalyse additional investments.

It is envisaged that the African Water Facility will operate through a number of different windows, providing:

- Grants for Sub-Regional and Trans-boundary Water Resource Management Program Development;
- Grants for National Level Reforms, Strategy Plans and Legislation: This would provide incentives for and support to those governments that propose to implement sector reforms through necessary legislation amendments and institutional reforms. Grants would support activities such as: cost of developing the reform program, meeting initial labour costs of rightsizing central ministry and local authority staff structures, or the costs of safety nets or easing the political costs of tariff reforms and of well-targeted subsidies for the poor in the context of local tariff reforms. A specific focus of grants would be to assist countries incorporate water more centrally in national poverty reduction strategies;
- Budget Support for Water Investments: This window will provide budgetary support to countries, where political commitment is high, the policy framework adequate and where there is an appropriate institutional structure, for Water sector operations through a loan-grant mix; and
- Grants to Establish a Benchmarking and Monitoring Facility: this would provide comparative performance assessment for all African countries on agreed performance indicators to assess: a) level of country commitment on IWRM and WSS sector reforms, b) progress on implementation of IWRM and WSS sector reforms, both institutional, financial and coverage, c) overall country framework for fiscal and governance reforms, d) progress and performance on development and implementation of country's PRSP, and e) extent and nature of IWRM and WSS components in country owned poverty reduction strategy papers.

A wider problem of project design not explicitly captured by these initiatives relates to the problem of insuring against issues of water mis-allocation among different users (competing uses for irrigation, potable water and environmental preservation). For example, pricing policies for irrigation based on non-cost recovery can negatively affect the allocation of water resources for other uses (e.g., industry, public water supply). In these cases, there is a need to further develop the objectives of IWRM within the project preparation process, an issue of pertinence to the EU Water Initiative.

3.3.5

A Lack of National Capacity

Another common constraint identified is the lack of capacity within country to design, implement or regulate new water sector projects. Capacity constraints can be prevalent in the public sector, the local private sector and in civil society.

A lack of public sector capacity, particularly at the local level and following a process of decentralisation, is commonplace. Often, this manifests itself in the difficulty public sector employees have in shifting from being service providers to regulators; from being lobbyists seeking funds from central government to “clients” overseeing consultants developing project designs for their town or region; or from being part of a centralised line ministry to an autonomous decision maker deciding upon the most cost effective way to set and manage budgets, meet targets and utilise a range of revenue, grant, subsidies and debt-financing options.

A lack of local private sector capacity can also be an associated problem. Often the local private sector has limited experience in providing elements of the supply chain for water supply projects, as this was traditionally the role of large public sector agencies; consequently dealing with contracts, time-bound or output-based responsibilities for service delivery and cash management issues can often be difficult without the requisite project or business management skills in place.

Finally, there is often a problem of a lack of capacity among civil society to cope with new approaches for water project delivery. NGOs have to shift from being solely implementers where previous gaps in public sector delivery existed, to also becoming advocates of change and best practice within the public and private sector. A better understanding of financing, regulatory and contractual issues is required. Similarly, local communities and water user groups, when given the space to design, manage or implement their own projects, may also need capacity building in skills such as decision-making, accounting and bookkeeping, monitoring and evaluation and communication and negotiation with key stakeholders in government and the private sector.

3.4 ***HOW CAN THESE CONSTRAINTS BE MITIGATED, SO AS TO LEVER MORE FINANCE INTO THE WATER SECTOR?***

3.4.1 ***Introduction***

Given these groups of constraint, this section explores how EU aid might be used more effectively to help overcome them, in order to leverage more and different forms of finance into the water sector.

To help guide this analysis, reference was made to the long list of proposals and recommendations related to attracting more finance into the sector, which the World Panel on Financing Water developed (pp14-34 of their final report). These proposals were grouped broadly under two headings - Governance and Sector Reform and Financial Instruments and Facilities - and were then clustered under the sub headings, as shown in the box below.

Issues about which the World Panel on Financing Water offered proposals

Governance and Sector Reform	Financial Instruments and Facilities
<ul style="list-style-type: none"> • Central Government • Sub Sovereign Entities • Promoting Local Capital Markets and Savings • Sustainable Cost Recovery • Increasing Managerial Capacity • Corruption and Ethical Practices • Legal and Regulatory Environment 	<ul style="list-style-type: none"> • Multilateral Funding Institutions • International Commercial Lending • Export Credit Agencies • Private Investment and Operation • Community Initiatives and Service Orientated NGOs.

This list contains over 150 separate proposals and recommendations and there are many detailed and useful ideas, which the EUWI can draw upon from this report. However, while the Panel’s proposals contain many sound ideas in principle, the practical “how-to” component of their proposals, may be less immediately apparent to decision makers involved in the EUWI

Consequently, and building on the Panel’s work, the focus of the EUWI and its finance component is to pinpoint *specifically* for the EU aid family where better focused EU aid could help to leverage in more and other sources of finance for the water sector. Thus, the areas for action in this report are presented a little differently to the Panels’ portfolio of proposals. To maintain a practical policy focus for the EUWI, some suggested ways of using EU aid more effectively, in order to overcome these key constraints and leverage in more and other forms of finance, are presented. However, these are done so from the perspective of the four key stakeholder groups who will be most involved in the EUWI, namely

- Water users;
- Water service providers;
- Government – both sub-sovereign and sovereign entities; and
- The EU Development Agencies themselves.

A set of summary figures is presented for each of these stakeholders. The figures show how different stakeholders could leverage different financing mechanisms and sources, by using EU aid resources in different ways, to best alleviate the particular constraints they face.

On the top left hand side, each figure lists the most pertinent constraints that each particular stakeholder faces in mobilising more finance for the water sector. On the bottom left hand side, each figure lists the methods of most relevance to that stakeholder for mitigating these constraints, through more effective uses of EU aid and resources. Finally, on the right hand side, each figure lists the most relevant possible sources and mechanisms of finance, which could become potentially available to the stakeholder, once those

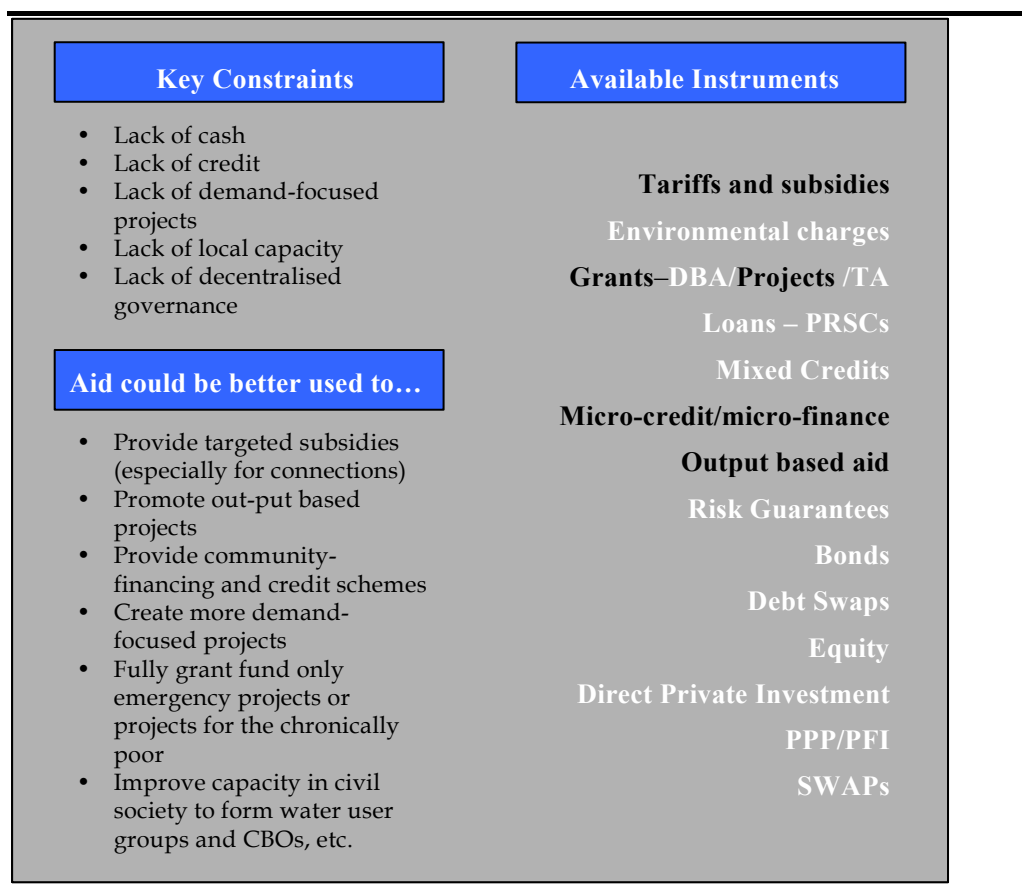
constraints have been mitigated. There is a defined menu of financing sources and mechanisms for all stakeholders, but those of most relevance to each stakeholder are highlighted in bold.

Each figure is accompanied by some explanatory text, and where relevant, some of the World Panel’s proposals are also highlighted as supporting material.

It is hoped that the presentation of findings in this manner pinpoints the “how to” factor, providing a clear signal about how best to target EUWI finance for each type of water sector stakeholder. Although general in nature as presented here, these figures should also be flexible enough to be adapted by each regional component of the EUWI, to help show where EU aid and resources could be used most effectively in each region, for whom, and with what expected outcomes.

3.4.2 *Mitigating the constraints to finance for water users*

Figure 3.1 *Summary of financing issues for water users*



The willingness and ability of domestic water users to generate finance to pay for their water services in a sustainable manner is of critical importance. If there is no revenue stream being generated to cover costs, the network or equipment will break down and need replacing again - aid dependency will continue. If there is no revenue stream apparent in the long run, there will be no interest from those external sources of finance wishing to derive a return on their investments or loans. If users are not paying for the service, they will take less interest in sustaining it themselves.

However, if the focus is on increasing investment in water services to meet the EUWI's goals (the MDG targets), the users in question are likely to be poor. How can they afford to pay? Who would loan money or offer credit to them? How can EU aid and resources best tackle these problems?

Figure 3.1 suggests that the key constraints to water users accessing more finance cover, commercial, governance, project design and capacity issues. Specifically, they include a lack of access to cash and credit, a lack of a decentralised space within which to manage their affairs autonomously, a lack of well designed demand-focused projects; and a lack of capacity among local user groups to design, manage and implement water and sanitation projects.

Potential ways of helping water users to leverage more of their own and others finance into the sector include through tariff and subsidy reform (allowing them and helping them to pay for the type of project they actually want), grant-based "kick-start" projects where necessary, supporting credit initiatives, and through the use of micro-finance and output based aid initiatives.

The World Panel also draws attention to the need for sustainable cost recovery to be stimulated from water users, via appropriate tariffs (including local cross subsidisation and increasing block tariffs), targeted subsidies, capacity building of civil society, the use of micro-credit and seed capital, and participation in user-managed (demand led) schemes.

But how can the EUWI help achieve this?

EU grant-based aid could be more effectively used to help water users trigger these extra forms of finance through paying for the provision of targeted subsidies (especially for connections); the start up of community-financing and credit schemes; helping to design and create more demand-focused projects; promoting output-based projects; and, importantly, developing the capacity within civil society to form water user groups, CBOs and other local civil society institutions. Full grant funding may only be necessary for emergency projects or projects for the chronically poor in extremely remote areas.

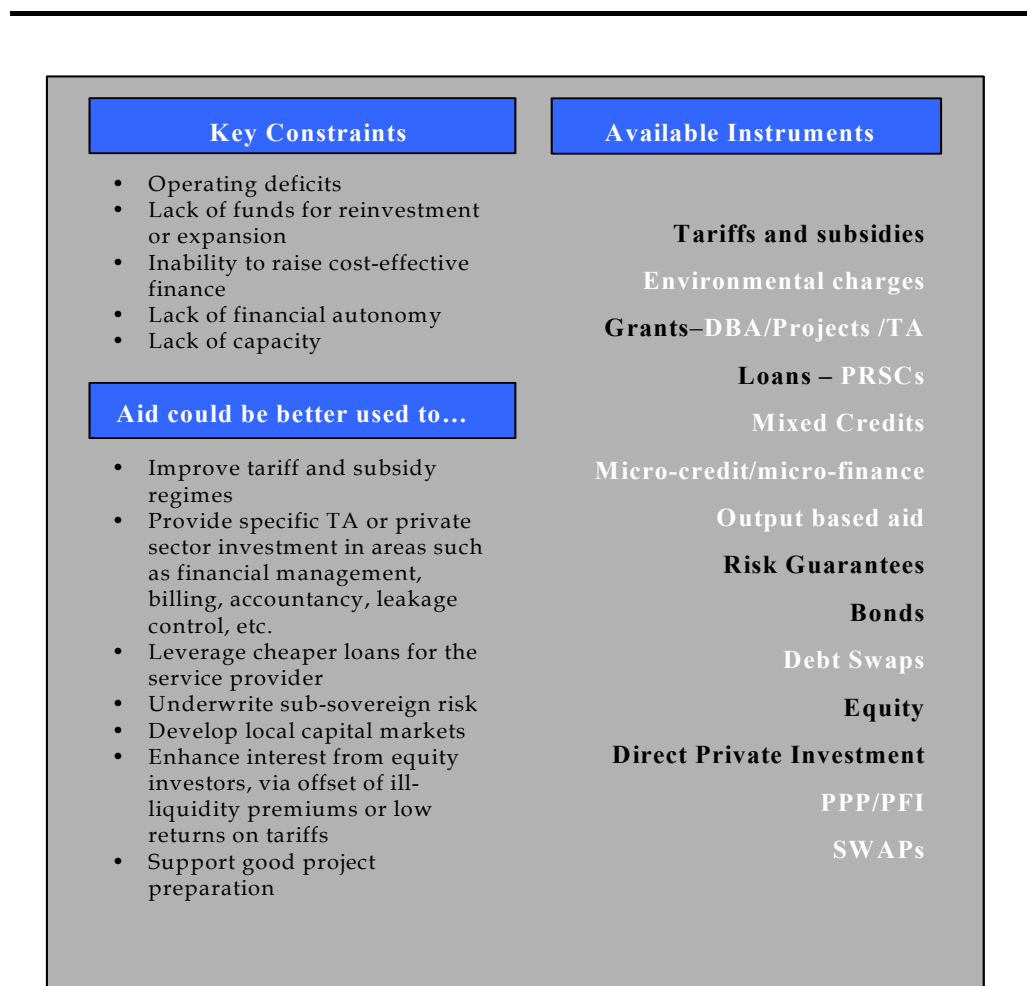
While some EU aid programmes may support such initiatives, they may not be coordinated or targeted toward the most needy countries. For example, there is not a systematic EU wide aid mechanism that provides demand-led support to water users to help them trigger their own or local sources of finance, especially in rural or peri-urban areas (or in lesson learning from successes in this area).

Many EU based research centres and INGOS work extremely effectively in this domain, forming networks of local alliances with domestic NGOs in identifying or delivering demand-led and sustainable water schemes for poor people. Support in their efforts to scale up activities and, importantly, to develop capacity, may be effective areas of focus for harmonised EU aid and resources. While the World Panel advocates the creation of funds in each regional development bank for NGOs to use in order to develop capacity, it may be the case that some existing civil society capacity building programmes from within the EU aid family can be identified, and then replicated or adapted with the support of the EUWI to meet the requirements of water users in each regional component.

3.4.3

Mitigating the constraints to finance for water service providers

Figure 3.2 Summary of financing issues for water service providers



Those countries, which the EUWI’s goals are most focused upon, are the highly indebted poor countries (HIPC’s). Water service providers in these countries are generally going to be public sector agencies with a responsibility for providing water and sanitation services to a regional area or a municipality. They will generally be managed at the sub-sovereign level (unless, perhaps, the water service provider is providing for the capital city). In some cases, with support from their public sector owners, they may have contracted out part of their remit to private sector operators (billing, collections, maintenance tasks for example). Generally, however, the service provider is likely to be over-stretched, under financed and providing as best a service as possible, given very difficult financial conditions. The management mode of the service provider is more likely to be that of short-term crisis mitigation rather than long-term and strategic.

Figure 3.2 suggests that the key constraints to these kinds of water service providers accessing more finance concern commercial and capacity issues (with governance constraints tending to lie outside of their control). Specifically, these constraints include a lack of day-to-day cash revenue and a wider inability (for commercial or wider governance reasons) to raise cost effective finance. A lack of capacity in finance and strategic management capabilities, rather than technical water issues, may also be a common constraint.

Potential ways of helping water service providers to leverage more finance into the sector include through tariff and subsidy reform (and improved billing and collection procedures) and through stimulating a mixture of finance sources including loans, raising bonds, encouraging equity stakes and direct private investment in their organisations. The use of commercial risk guarantees could also help to attract this finance; though it is unlikely the water service provider would be able to offer much guarantee to a debt provider without wider government help.

The World Panel also draws attention to the plight of water service providers, particularly in relation to its set of proposals at the sub-sovereign level. The Panel proposes more training, partnerships and associations, standardised contracts for private sector participation, benchmarking of their performance and technical assistance in project preparation, to broadly help develop capacity. In relation to the (sub sovereign) commercial constraints facing water sector providers, the Panel suggests a range of options including more secure transfers of central funds, more clearly defined fiscal relationships with Government, better access to long term credit markets, technical assistance for better project development, concessional financing from donors for water projects and the freeing up of more water service provider's operations to be privately financed and managed.

While the boundary between the sub-sovereign and the water service provider is inevitably blurred, it is however clear that EU grant-based aid could be used effectively to help water service providers in a number of ways. By providing various forms of technical assistance or output-based aid in areas of strategic development, price reform, accountancy improvements, customer services and billing and collections (generally corporatising the entity) a gradual change to a more commercially minded organisation could be instigated. A focus on capacity building (via twinning, association forming or focused consultancy inputs) could also be supported. Grant aid could also be used to support changes to the wider financing space within which the service provider operates, for example by helping to identify and negotiate (and provide) affordable loans for the service provider; by underwriting some of the risk of these loans and by exploring how to develop local capital markets to enable the provider to raise more local currency finance.

Similarly, EU grant-aid could be used to enhance interest from external commercial lenders or equity investors in the service provider, by using aid to off set of ill-liquidity premiums or their generally low returns on tariffs; or perhaps to subsidise EU-based finance institutions to provide below market rates for loans the service provider may wish to take on in order to pursue service delivery in poorer parts of its customers base (peri-urban or rural areas, for example), perhaps through the use of institutions such as the Emerging African Infrastructure Fund. Across all of these activities, access to grant-finance facilities and expertise to develop good quality proposals to embark on these changes is also an important area where well-targeted EU aid could play a key role, perhaps via the PIDG's DevCo facility, or within the aegis of the African Water Facility for sub-Saharan Africa or the project Preparation Committee, in the EECCA region, or even via regionally developed mechanisms similar to the World Bank/ TACIS Joint Environment Programmes for environmental infrastructure (See *Annex D*).

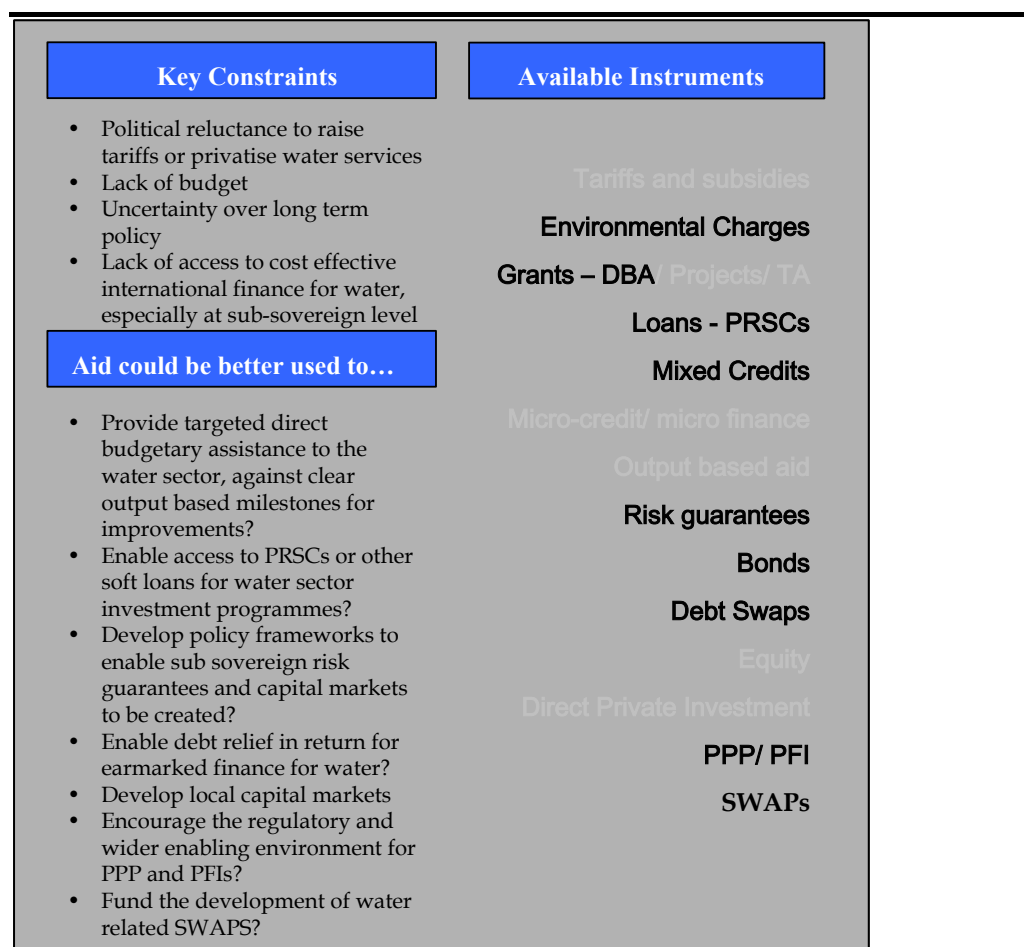
Again, while some EU aid programmes may already support such initiatives, they may not be coordinated or consistently targeted toward those service providers most in need of support in key HIPC countries. The likelihood is also that they may not form part of a systematic EU wide approach to provide support to water service providers to help gradually commercialise their entities, develop good quality projects, or mobilise local or intentional forms of finance at affordable rates. The EU aid family also rarely jointly supports centres of excellence where, for example, service providers can access national (and international) expertise across the range of disciplines required for water sector reform processes and where they can also cross share and access information, experiences and contacts.

Finally, it also becomes clear that while coordination in the aid delivery process is critical to ensure harmony between the development of the potential of water users and water service providers to overcome their constraints and better access finance, to a large extent these programmes can not take place without involving concurrent changes in the wider governance arenas, at the sub sovereign and national levels. It is thus probably in the area of governance reform, at sovereign and sub-sovereign level, where the EUWI should try to exert most influence.

3.4.4

Mitigating the constraints to finance for government

Figure 3.3 *Summary of financing issues in the wider governance sector*



Stakeholders in the wider governance environment include both sovereign (national government) and sub sovereign (local or state government) entities.

Figure 3.3 suggests that the key constraints to Government at both levels accessing more finance for water relate broadly to the issue of minimising the perception of political risk – water governance issues. These are large challenges to overcome and may include a mixture of some or all of the following.

At both sovereign and sub sovereign levels

- A political reluctance to decentralise water responsibilities, to reform tariffs and subsidies or to encourage more involvement from the private sector or private finance;
- Budgetary constraints due to the problem of competing social demands, especially from health (HIV) issues;
- A lack of a long-term strategy or vision for development and investment in the water sector, either as part of or separate to the PRSP process;

- A lack of understanding about how (or reluctance to) adjust policy to better access cost-effective domestic and international finance for water; and
- A lack of capacity within authority to create the right sorts of financing policies; to develop robust designs for financially sustainable water supply projects for the poorest people; and to adjust staff roles and skills from being responsible for service provision to being responsible for regulation and project management and evaluation.

Some issues, particular to the sovereign level may involve a lack of clarity over the fiscal relationship between the centre and state government; a lack of support from the centre to guarantee or provide security on fiscal flows to the sub-sovereign level; a weak or unclear national legal and regulatory structure within which sub-sovereigns can operate their water sectors; an unclear policy lead on issues of private sector participation or the use of private sector finance in water sector activities; a low prioritisation of water sector issues within the national PRSP; and an unclear policy lead on the roles and responsibilities of the public sector, the private sector and civil society groups in the provision of water sector services.

Notwithstanding sub-sovereign variants of the issues mentioned above, some further governance issues particular to the sub-sovereign level may include a lack of capacity within the public sector to act upon the opportunities for attracting a wider range of finance into state government for sectors such as water; a lack of ability to provide adequate financial guarantees; and a higher level of political interference in “local” water issues such as tariffs and subsidies.

However, the table shows that there is a potentially wide range of mechanisms available for national and local government authorities to deploy to improve their governance environments and thus to attract more finance into the water sector. These include:

- The development of financially sustainable tariff and subsidy policies;
- The use of environmental charges to raise finance and change behaviour of large-scale water abstracters and polluters;
- The better use of donor grants, direct budgetary assistance for water and the accessing of soft loans such as PRSCs (which would, of course, be dependant on a PRSP which identified water as a key poverty reduction priority);
- The exploration of the use of certain donor mixed credit or export fund schemes for providing the investment for water projects;
- The development of the “right kinds” of institutional and policy environments conducive to creating local capital markets; and
- Exploring with EU donors the potential for debt swaps for water;

- The use of PFI and sector wide approach programmes for water sector investments.

The guidelines set out in Annex E may provide a useful start point as to the vision of what good water governance should look like, and what the respective roles and responsibilities of the public and private sector and civil society may be.

The World Panel's proposals related to sovereign and sub sovereign entities also broadly echo these suggestions, with perhaps a stronger focus on the development of financial solutions at the sub sovereign level. At the national government level, the Panel usefully suggest a range of plans, indicators, awareness raising and common standards on best practice to increase the prominence and transparent governance of the water sector. At the sub sovereign level, they propose a range of financing mechanisms: *inter alia* the promotion of credit ratings, the promotion of domestic borrowing markets, the encouragement of bond insurance and financial guarantee companies, the creation of joint credit pools, the provision of partial security to sub-sovereign lenders, more use of donor provided technical assistance for project preparation, the use of concessional donor finance for water projects and the use of partial credit guarantees to raise more bonds in local currency.

Hence, in practical terms there could be a wide range of productive activities which well targeted EU aid could be put toward as part of each regional component of the EUWI, to help develop the right kinds of governance framework at the national and sub-national levels. The aim would be for these better-targeted aid packages to stimulate more investments into the water sector from a range of finance sources.

These practical activities may include:

- Capacity building programmes for public sector staff at national and sub-national levels on the changes they should expect in their roles (service providers to regulators) and how to manage that process;
- Practical workshops, skills transfers and centres of excellence for water policy development (for example on introducing water into the PRSP process, on decentralising the water sector, on tariff and subsidy reform, on using the principles of IWRM to underpin water policy, and on issues of aggregation and pro-poor regulatory reform), followed by grant funding and technical assistance for subsequent policy development;
- Technical assistance and training on the introduction of finance issues into water policy and management procedures (for example on the design and implementation of PPP and PFI initiatives for water; on the development of local capital markets or the opportunities that may exist in the

international capital markets for raising finance for the water sector; on financially viable project preparation; on assessing the levels of debt to equity ratios that may be optimal for the public sector authority to sustain for developing sustainable finance strategies for the water sector; on the potential for assessing the credit worthiness of key municipalities and developing risk guarantee mechanisms with the EU donor community for them)

As well as the better and more coordinated use of technical assistance, there may also be plenty of potential in assessing how the EUWI regional components can support governments to make the best use of various infrastructure related or wider multi-donor financing initiatives, either to prepare projects (DevCo, PPC, AWF); to underwrite risk (GuarantCo); to provide concessional loans (*inter alia* EIB, EAIF, AWF, CLIFF); or to reform public financing systems, accountancy procedures and utility price regulations (such as through programmes like FIRST).

3.4.5 *Mitigating the constraints to more effective financing facing the EU Aid Agencies*

Figure 3.4 *Summary of financing issues facing the EU aid family*

Key Constraints	Existing Mechanisms
<ul style="list-style-type: none"> • Low volume of aid committed to the water sector • Aid is not used as effectively as it could be (going to less needy countries and less urgent projects, not really leveraging other forms of finance) • Low levels of coordination or harmonisation between water programmes • Low demand for water from recipient governments • High transaction costs for recipient governments dealing with multiple EU aid donors for water • Poor information transfer between EU aid donors on water 	<ul style="list-style-type: none"> • Agreements for (water sector) aid finance and targets such as Bonn, Monterrey, Cotonou, WSSD MDGs • EUWI secretariat • PIDG and other existing multi donor finance-related mechanisms (DevCo, GuarantCo, EAIF, AWF, PPC, CLIFF, Probarco, PPUE) • PPIAF and other multi-donor funds for TA to analyse related wider policy constraints (tariffs, regulation, decentralisation, benchmarking) • Policy influencers such as EAP task force, NEPAD (AMCOW), WSCC, WWC, GWP, WSP • Effective capacity building programmes within EU aid portfolio including partnerships with the private sector (such as BPD, PAWS, WUP). • DAC database to track disbursement against commitment
<p>EU aid could be made more effective by...</p>	
<ul style="list-style-type: none"> • Reaffirming policy and budget commitments to the water sector within the framework of the EUWI • Refocusing water sector aid to be a tool for mitigating the constraints that block other forms of finance flowing into the sector; especially in relation to governance, capacity and project development issues • Using the EUWI as a framework for better harmonising and targeting EU aid flows to water; • Committing water sector aid to support multi-donor mechanisms that influence policy, attract private sector finance or undertake targeted policy development or analyses • Allowing EU aid flows to the water sector to be better monitored and evaluated in relation to EU aid obligations 	

Figure 3.4 indicates that there is also a range of activities that the EU aid family can concentrate on, to improve their effectiveness in tackling the water financing challenge, as part of the EUWI process. These activities broadly fall under the headings of

- Leverage
- Harmonisation
- Awareness raising

Leverage

As an overriding issue the EU aid family should work on ways to leverage maximum financing from the private sector and users into the water sector. It must be recognised by the EU donors that, at present, the water sector has much lower leverage ratios than other utility sectors in developing countries.¹ A key marker for the EUWI could be that it succeeds in improving the leverage ratio of EU public money to EU private sector investment and user finance. This may be a more important issue to focus on, than lobbying each other to commit more aid to water. The real challenge, the water professionals in the EU aid agencies must face as part of the EUWI, is not how much more aid can they get committed, but how much more effective can they make existing aid commitments become?

Harmonisation

Parallel to the challenge of aid effectiveness is the issue of transaction costs. Only by harmonising approaches and procedures as well as goals, will the marginal benefit of using extra EU aid for the water sector be clear to recipient governments. More aid with more strands of bureaucracies from each agency is not attractive. Yet the devil, as always, is in the detail. The challenge of harmonising fifteen different bilateral aid approaches and procedures, plus a range of multilateral programmes, may prove much harder for the EU aid family to achieve, than agreeing upon a set of common EUWI goals or criteria for success. This is another key area for EU water sector professionals to focus their time and resources on.

In fact, coordinated funding may be most efficiently organised at a regional level, within each regional component of the initiative taking on the challenge of regional harmonisation. Similar initiatives have already been developed for

(1) For example, in the water sector, between zero and USD 1 of private money is invested for USD 1 of public money, whereas the telecommunications sector has a leverage ratio of USD 2-6 of private money for every USD1 of public money invested, and the electricity sector has an even ratio of around USD 1 of private money invested for each USD 1 of public money.

the EECCA region, following the “Environment for Europe” process. In the case of the EUWI Africa component, for example, AMCOW could be used as a direct interlocutor to help coordinate how to harmonise aid flows from the EU donors and lower transaction costs for recipient governments.

Establishing information channels. External funding is likely to come from a variety of actors, including Member States and multi-laterals but also private operators and financiers. At a regional level again, the EU Water Initiative could serve to act as a single information channel to recipient countries for flows of funds coming from the European Union, and to provide assistance in understanding how to tap into those sources of finance.

Importantly, however, meeting the challenges of creating a better leverage ratio and improved harmonisation does not necessarily require EU agencies to develop a plethora of new initiatives or institutions. Plenty of programmes and frameworks exist within the EU aid architecture already, for the EUWI to graft itself onto.

In terms of the leverage ratio challenge, for example, multi-donor funds or initiatives such as PIDG, PPUE, Proparco, CLIFF, PPC, AWF *et al*, and the range of mechanisms they support are clear partners for the EUWI to influence and channel resources into. Mechanisms for improving the leverage ratio of aid to various sectors or regions exist: the EUWI can be put to work to strengthen and sharpen them from a water sector perspective.

In terms of the harmonisation challenge, a range of policy institutions and fora exist that can be utilised by the EUWI to help guide the coordination process. These include bodies such as the OECD, the GWP, the WSCC, the WSP and regionally specific interlocutors such as AMCOW and the EAP Task Force. The OECD DAC can also be used to ensure more robust tracking, monitoring and evaluation procedures to measure success, based upon the goals of the EUWI.

There is also a range of twinning, public-private partnership or other professional association initiatives that exist within the water sector, which the EUWI can support to bolster the issue of skills transfer and capacity building. These include the BPD component for water, the WUP and the UK PAWS among others. Wider capacity and policy building initiatives that already look into issues such as regulatory policy, tariffs, decentralisation and industry structures for example include funds such as PPIAF. The EUWI could support PPIAF to undertake more work on the kinds of capacity and policy-building issues, which will be needed in particular EUWI regions or countries, if the harmonised aid and the leverage it aims to create, are to be put to best effect.

This report has also shown that there is currently inadequate statistical information on the existing funding of the water sector, future commitments

and estimated needs to meet the Millennium Development Goals or Vision 21 targets. In addition, there is no centralised source of information on EU aid flows to the EUWI regions, constraining the ability to benchmark progress or disseminate results. Further, aid flows could be more effectively coordinated through a wider reconciliation with other non-EU sources, if more information were available. Therefore, additional analysis is required to identify potential overlaps and gaps between assistance programmes carried out by EU Member States and institutions (within the context of the wider donor community), and areas where efficiency gains could be generated from a better coordination of EU aid flows with other aid flows. The OECD DAC database and the resources allocated to it, is the obvious mechanism for the EUWI support in this data collection and analysis process.

Awareness Raising

A key challenge for water sector professionals in the EU aid agencies is that the demand for a more effective flow of EU aid to the water sector needs to come more strongly from developing countries themselves. It is not really emerging out of the PRSP process to date.

However, the EUWI could help to focus attention among recipient governments on the usefulness of its goals to them.

With better communication, for example, about the EUWI's financing strategy, in particular the desire to obtain a better leverage ratio for water related aid (hopefully stimulating the domestic private sector, local capital markets and external investments as a result); the desire to build capacity in key areas of regulation and utility policy; and an overall desire to reduce transaction costs for recipient countries, the case for water should become more attractive. As a result, EUWI-related activities might start to emerge more prominently in PRSPs than they do at present. ⁽¹⁾ Additionally, it could also be made clear that additional requests for funding for such EUWI-related activities, especially if featured in the PRSP, would be very well received by the EU donor community. ⁽²⁾

(1) Further, by framing water within the broader and integrated context of sustainable governance, social and economic development, the EUWI could avoid the problem of being perceived to over-stress one sector at the expense of another.

(2) Some participants in the Finance Working Group suggest going further with this point by creating a commitment by members of the EUWI similar to that made by the G8 with regards to the education MDG such that "no country genuinely committed to poverty reduction, good governance and economic reform will be denied the chance to achieve the Millennium Development Goals (for water and sanitation through lack of finance)"

The EU Water Initiative is not developing in isolation: it sits within a wider architecture of aid and finance mechanisms. A range of frameworks and initiatives for improving the financing of infrastructure in developing countries and in particular, financing to the water sector, already exist. A series of policy declarations have also shaped the way in which the financial challenge can and should be addressed.

This section presents a summary table of the existing policy, sector specific and financing initiatives that relate to the water sector and which provide the context or “building blocks” for the EUWI. More details on each initiative are provided in *Annex D*.

Some of these initiatives may be useful complements of the EUWI and some could potentially be extended at the European level. It is recommended that each regional component expand upon this review at future stages of the development of the initiative, seeking those linkages of most use to its particular agenda. This is especially important, if the EUWI is to build on existing initiatives as much as possible, in order to lower transaction costs for potential users, rather than invent its own new bureaucracies.

The initiatives have been grouped under the following headings:

- *Policy initiatives and international agreements* that shape the way in which development assistance can be provided globally and in the EU;
- *Water-specific policy initiatives*, focusing on the most recent initiatives that form the conceptual basis of the EU Water Initiative;
- *Non-water specific financial initiatives*, which have developed innovative financial vehicles that could potentially be tapped into by the Initiative;
- *Water Specific financial initiatives*, specifically the proposed EU Water Fund
- *Global water initiatives*, which tend to act as knowledge networks and have accumulated considerable expertise on the water sector;
- *Country-specific water initiatives*, which have been developed by one donor in particular or for a particular recipient country or region.

<i>Name of initiative</i>	<i>Acronym</i>	<i>Nature</i>	<i>Source</i>	<i>Regional Focus</i>	<i>Key outputs/Instruments</i>	<i>Relevance to the EUWI</i>
1 Policy initiatives						
World Summit on Sustainable Development	WSSD	Policy setting	Global	Global	Agreed to mobilise international and domestic financial resources for WATSAN investments. Support for a "world solidarity fund" agreed upon in Johannesburg	Johannesburg summit: launching of the initiative in a favourable climate. <i>EUWI will need to coordinate with new global financing instruments proposed</i>
The EU/ACP Partnership Agreement	Cotonou	Aid agreement	European Union	ACP	Financial protocol for ACP countries and guidelines for aid provision	<i>Has increased the profile of water within EU ODA. EUWI could seek to build upon proposed investment facility</i>
New Partnership for Africa Development	NEPAD	Policy setting	Africa	Africa	Policy principles: increase financial investments in infrastructure by lowering risks facing private investors, with respect to policy/regulatory frameworks. Clear emphasis on governance.	<i>Direct interlocutor in Africa</i>
African Ministers Conference on Water	AMCOW	Policy setting Under NEPAD	Africa	Global	Key objectives for reviewing the development of the water sector	<i>Direct interlocutor in Africa for EUWI</i>
Environment for Europe Process	EEP	Policy setting	Ministers	CEE and NIS	Policy process and set up the EAP Task Force and the Project Preparation Committee	<i>Led to the creation of initiatives which provide a good basis for the EUWI</i>
2 Water specific policy initiatives						
EC Resolution on Water Management in Developing Countries		Resolution	European Union	Developing countries	Initiated the EU Water Initiative and stresses the need for good governance and to strengthen coordination within the European Union	<i>Key policy basis for the EUWI</i>
Bonn Recommendations for Action		Policy declaration	Global	Global	Detailed analysis and statements about financing the water sector	<i>Conceptual basis for the EUWI</i>
3 Non water- specific financial initiatives						
Financial Sector Reform and Strengthening	FIRST	Technical Assistance Grants	Donors (UK largely involved)	Global	Technical Assistance support for reform of the financial sectors	<i>Addresses the broader financial framework – EUWI initiative could piggyback on some innovations or countries where reform successfully implemented.</i>
Public Private Infrastructure Advisory Facility	PPIAF	Technical Assistance Grants	Donors (UK, Japan, World Bank)	Global	Technical Assistance grants to support private sector participation in the infrastructure sector	<i>Addresses institutional and regulatory issues – EUWI could act in areas where reforms successfully implemented</i>
Environmental Action Programme Task Force	EAP	Task force	Governments & OECD	CEE and NIS	Has identified urban water sector reform in the NIS as one of its key priorities.	<i>The EUWI could use the knowledge and practical tools developed by the EAP task force</i>

Environmental Resources Management

DFID/ European Union

<i>Name of initiative</i>	<i>Acronym</i>	<i>Nature</i>	<i>Source</i>	<i>Regional Focus</i>	<i>Key outputs/Instruments</i>	<i>Relevance to the EUWI</i>
Project Preparation Committee	PPC	Coordination of IFIs	IFIs (hosted by EBRD)	CEE and NIS	Innovative networking mechanism for coordinating assistance to CEE and NIS. Has allowed financing for the environmental sector to be allocated more effectively	<i>The EUWI could consider this type of mechanism for other regions in order to develop Project Preparation Facilities</i>
Joint Environmental Programme	JEP	Financing Vehicle for Technical Assistance	Multilateral donors (WB/EC)	NIS and Mongolia	Mechanism for funding feasibility and preparation studies for selected investment projects	<i>The EUWI could consider this type of mechanism for other regions in order to develop Project Preparation Facilities</i>
Private Infrastructure Donor Group	PIDG	Project financing	Donors (Neth, Sweden, Switz., UK)	Global	The group aims to mobilise private investment and controls a Trust, based in Mauritius, that can support initiatives such as EAIF and others under preparation (see below)	<i>EUWI could scale-up with the inclusion of additional EU members in the group.</i>
Infrastructure Development Company (Planned)	DevCo	Project Preparation	Multi-donors, UK-led	Global	Creation and structuring of infrastructure opportunities and presentation of these opportunities to the private sector through a competitive and transparent process	<i>Focuses on the need to prepare good projects. EUWI could scale-up.</i>
Development Guarantee Company (Planned)	GuarantCo	Guarantees	Multi-donors, UK-led	Global	Partial risk guarantees for local currency bonds issued by municipalities and utilities for infrastructure work	<i>EUWI could scale-up.</i>
Emerging Africa Infrastructure Fund	EAIF	Long Term Loans	Multi-donors (UK, Sweden, Switz., Neth.) and banks	Africa	Long-term lending to infrastructure companies (including water and sanitation) for the poorest countries, focusing on Africa. Coordinated approach between donor and banks, including commercial and development banks is an innovation.	<i>The EUWI could consider a similar approach for replication, with a focus on water or provide more resources to EAIF for water</i>
Public Private Partnerships for the Urban Environment	PPPUE	Grants	UNDP and Donors (UK, Switz, New Zealand)	Global	Innovative partnership grants for projects and activities establishing adequate policy, legal and institutional frameworks for PPP at local level particularly at the urban level	<i>Grants for establishing conducive institutional environment: impact on risk reduction. EUWI could scale-up.</i>

<i>Name of initiative</i>	<i>Acronym</i>	<i>Nature</i>	<i>Source</i>	<i>Regional Focus</i>	<i>Key outputs/Instruments</i>	<i>Relevance to the EUWI</i>
Community-Led Infrastructure Financing Facility	CLIFF	Project financing	UK and NGOs	India	Loans/ credit guarantees to community-led slum upgrading initiatives	<i>EUWI could scale-up.</i>
4 Water specific financial initiatives						
EU Water Fund	EUWF	Sector specific finance	EU member states; EC	EC ACP	Proposed one billion euro fund to support the EUWI. Providing co-financing and capacity building	Potentially of interest, but some key issues need addressing: <i>The potential bypassing of the EDF investment facility</i> <i>How to manage it without creating a new bureaucracy or agency, thus raising transaction costs</i> <i>How to make sure a sector-specific fund does not distort country-led, demand driven processes for aid requests., such as within the PRSP</i>
5 Global water initiatives						
Global Water Partnership	GWP	Partners network		Global	Knowledge network – Ongoing initiative focusing on governance issues	Governance issues are crucial to ensure better performance of aid flows to the water sector – <i>EUWI to build on results</i>
World Water Council	WWC	International think-tank and network	INGO	Global	Key influence on the agenda for the World Water Fora	<i>EUWI to build on the WWC</i>
The World Panel on Financing Water Infrastructure	Camdessus International Panel			Global	Camdessus paper presented at Kyoto.	<i>EUWI should draw on the research presented by the panel to inform its own decision making, and should build on the recommendations made in the report.</i>
Water Supply and Sanitation Collaborative Council	WSSCC	Cross between professional association and international NGO	Donors (UN)	Global	Knowledge network. Not a provider of finance but only seed money to influence organisations	<i>EUWI to build on existing knowledge and documents</i>
Water and Sanitation Program	WSP	INGO	WB and UNDP	Global	Seeks to influence policy in the water sector with strong regional presence. Ongoing projects	<i>EUWI should draw from ongoing projects analysing financing and in particular</i>

Environmental Resources Management

DFID/ European Union

<i>Name of initiative</i>	<i>Acronym</i>	<i>Nature</i>	<i>Source</i>	<i>Regional Focus</i>	<i>Key outputs/Instruments</i>	<i>Relevance to the EUWI</i>
					examining financing issues, at a relatively micro-scale but still focused on water services rather than IWRM.	<i>examining the role of micro-finance in Africa.</i>
Business Partners for Development	BPD	Tri-sector Partnership	Donors	Global	Particular focus on exploring the merits of tri-sector partnerships for water and sanitation services	<i>EUWI could consider scaling-up this initiative through additional involvement.</i>
Water Utility Partnerships	WUP	Professional organisation	UAWS	Africa	Created by professional organisation and training bodies in Africa. Prepared a toolkit for services to low-income communities.	<i>EUWI could build on this organisation to identify good projects in Africa.</i>
World Bank Water Resource	WB	INGO + network	WB, Neth, GEF, etc...	Global	World Bank is developing a Water Resources Strategy in coordination with other organisations	<i>EUWI could develop a similar water resources strategy but building a specific EU line on water issues</i>
6 Country-specific water initiatives						
The African Water Facility	AWF	Investment Support		Africa	Promote innovative actions, assist to create an enabling environment, help to build governance and management capacity	<i>The EUWI can use the AWF to channel funds for water projects in Africa.</i>
Tacis (water specific component)		Multilateral	European Union	NIS	Financing initiatives and programmes linked with the management of transboundary water bodies in the NIS	<i>EUWI could collaborate with Tacis for the management of transboundary water bodies</i>
Nile Basin Initiative	NBI	Direct investments	Donors	Nile	Providing finance to large projects in the Nile basin on the basis of an integrated river basin management approach	<i>Innovative example of multi-donor facility. EUWI could scale-up and expand to other river basins.</i>
Partners for Water and Sanitation		Professional partnerships	UK	Africa	Professional partnerships to develop access of poor communities to water and sanitation	<i>EUWI could potentially scale-up this initiative, although not directly financial</i>
Netherlands multilateral		Partnership donor and multilaterals	Neth.	Global	Also known as “the Dutch window”. Partnerships with multi-laterals and in particular with the World Bank but also other regional banks.	<i>Partnerships between donors and multilateral has proved efficient for focusing on water. EUWI could potentially scale-up.</i>

To address the core finance challenges identified by the EUWI, the financial component of the EUWI posed itself six questions.

1. How much extra finance is needed to meet the water and sanitation Millennium Development Goals?
2. How much finance is currently provided by EU overseas aid?
3. How much finance is provided by the private sector and domestic tax revenue or user charges?
4. Where are the gaps and overlaps in these finance flows, in relation to meeting the MDGs for Water and Sanitation?
5. What are the key constraints, which prevent these gaps from being filled?
6. How can these constraints be alleviated, so as to lever more finance into the water sector to meet the MDGs for water and sanitation?

General answers to the six questions were identified.

1. At least an extra USD9 – 30 billion per year will be required to meet the water and sanitation MDGs, mostly for sanitation. This doesn't include the challenge of financing IWRM.
2. Aid from the EU aid family will not be sufficient to meet the water challenge by itself, even if more is pledged. Even if Monterrey commitments are fully met, based on current percentage allocations to the water sector, less than a tenth of the lower bound estimate of the financial challenge will be met by EU overseas aid.
3. Currently private sector finance provides less than five percent of finance to the water sector in developing countries. Domestic finance (from users and taxes) provides the great majority. However, developing country governments tend to allocate very little of their budgets toward pro-poor water and sanitation services, less than one percent in many sub-Saharan African countries.
4. An analysis of finance flows in sub Saharan Africa shows that finance in the water sector goes less toward projects designed for the poorest and less to those countries that need finance for water most.
5. There are four groups of constraint that stop more finance being attracted and retained in the water sector in developing countries: commercial risks, political and governance issues, a lack of good projects and issues of capacity.
6. Current aid commitments could make a much more significant contribution to the problem if they were deployed to mitigate these constraints, thus "unlocking" the potential of the much greater volumes of user-finance and private sector finance that exist, to meet the financing challenge. A range of practical opportunities have been identified for the EUWI to increase the leverage and harmonisation potential of EU water sector aid; different approaches can be taken to ease constraints for different types of stakeholder – water users; water

service providers; governments at national and sub sovereign levels and among the EU donor agencies themselves.

Other issues also emerged during the investigation.

- There is a wide range of policy fora, water sector initiatives and finance-leveraging aid mechanisms for the EUWI to build upon, within the different EUWI regions. Consequently, there seems limited reason to develop new initiatives or bureaucracies to administer the EUWI finance, as this would only raise its transaction costs.
- Keeping the transaction costs of executing the EUWI down and highlighting the wider economic development benefits that the EUWI can bring to countries by improving the leverage ratios of EU aid to developing countries (such as attracting more foreign investment, supporting regulatory reform, assisting capacity building, helping to develop local capital markets etc) may help to increase the attractiveness of including water sector goals in PRSPs.
- The report of the World Panel on Financing Water Sector Infrastructure is an extremely useful reference for the EUWI ; the aim of the finance component has been to complement it, build upon it and help show how aspects of it can be practically applied within the context of the EUWI's own goals.

Finally, the *process* of investigation that was used by the finance component is also meant to provide a route map for the regional finance components of the EUWI to follow. This will ensure a consistency of approach and understanding across all the regional implementation strategies. It is hoped therefore, that this report and its annexes can be used firstly as a guide for each of the regional components to assess the financial challenge the EUWI faces in their own region and; secondly as a tool to help them develop their own financing strategies for using EU aid more effectively to overcome the challenges the water sector faces in their particular region.

Annex A

Current and Projected Financing Needs for the Water Sector

TABLE A1 - Estimated Current expenditure for the Water Sector

	<i>Source</i>	<i>Amount/year</i>	<i>Region</i>	<i>Assumptions</i>
1	Vision 21	US\$10-25 billion	Developing countries	Current estimates of annual expenditure on water and sanitation, based on “various UNICEF and World Bank publications.” No indication whether this assumes wastewater treatment, network expansion or replacement costs.
2	WaterAid	US\$27-30 billion	Developing countries	Derived from different sources with different methodologies (not discussed in detail); estimated amount represents the range where these other sources for the “water and sanitation sector” – doubtfully includes other facets of the water sector.
3	GWP	US\$70-80 billion	Developing countries	Total estimated annual investment in water and sanitation in developing countries.
4	World Bank	US\$70-80 billion	Developing countries	No explicit assumptions provided
5	PWC	US\$80 billion	Global	Based on estimates from technical discussion groups at the 2nd World Water Forum, on current expenditure. Does not elaborate on the types of service, or whether this includes all water sector activities or just water and sanitation (which would include water treatment facilities).

Sources:

1. “Vision 21: A Shared Vision for Hygiene, Sanitation and Water Supply and a Framework for Action.” P. 28. , also the “Water for People” Component in the World Water Vision presented at the Hague conference in March 2000. <http://www.wsscc.org/vision21/wwf/vision21.pdf>
2. Annamraju, S., Calaguas, B. and Gutierrez, E. “Financing water and sanitation: Key issues in increasing resources to the sector, A WaterAid briefing paper.” P. 2 November 2001. <http://www.wateraid.org.uk/pdf/financingfinaldraft.pdf>
3. GWP, “Towards Water Security: A Framework for Action,” p. 75. 2000. <http://www.gwpforum.org/gwp/library/sec3b.pdf>
4. World Bank Website: Infrastructure/Environmental Issues. www.worldbank.org/html/fpd/infrastructure/env/
5. Price Waterhouse Coopers, “Water: A world financial issue”, Page 22, March 2001. http://www.pwcglobal.com/fr/pwc_pdf/pwc_etude_uk-water.pdf

TABLE A2 – Estimated Projected financing needs to meet water sector development goals

<i>Source</i>	<i>Amount/year</i>	<i>Region</i>	<i>Assumptions</i>	<i>Basis for Calculation</i>
To meet the Millenium Development Goals (2015)				
(1) WaterAid	US\$ 25 billion	Developing countries	These figures are estimated to halve the number of people without access, and do not account for replacement costs, O&M, etc.	Est. US\$ 17 billion for sanitation, US\$ 8 billion for water supply
(2) World Bank	US\$ 9-30 billion	Developing countries		
(3) WSSCC (Camdessus)	US\$ 10 billion	Developing countries	Basic standards of service and technology	Est. US\$9 bn basic coverage Est. US\$30 bn universal coverage
(4) Lehman Brothers (Camdessus)	US\$ 17/US\$ 32	Developing countries	Full water and sewage connections and primary wastewater treatment to the urban populations	
To meet Vision 21 Goals (2025)				
(5) Vision 21	US \$9 billion	Pop. growth x low cost basic supply/sanitation (rural water: US\$15; urban water: \$50; rural sanitation: \$10; peri-urban sanitation/hygiene promotion: \$25 per person)	Developing countries	For low cost, basic water and sanitation, defined as a minimum of 20 litres of water/day for persons who understand their personal hygiene needs, and use a sanitary latrine.
(6) GWP	US \$180 billion for total water sector	Includes costing for irrigation, hydropower, and other facets of water sector.	For non-urban water systems	Note that estimates for drinking water and basic access to sanitation are \$13 bn and \$17 bn, respectively, in addition to the current expenditures of US\$13 bn for water and \$1 bn for sanitation
(7) PWC Report “Water: A World Financial Issue”	US\$ 180 billion	World Water Vision’s estimate of \$4,500 billion until 2025.	Globally (implied US&EU needs)	Note that these figures account for capacity extensions only, to the exclusion of renovation or rehabilitation work.

Sources:

1. Annamraju, S., Calaguas, B. and Gutierrez, E. "Financing water and sanitation: Key issues in increasing resources to the sector, A WaterAid briefing paper." May 2002. <http://www.wateraid.org.uk/pdf/financingfinaldraft.pdf>
2. "World Bank estimates cost of reaching Millennium Development goals at \$40-60 billion annually in additional aid," News Release no. 2002/212/S. <http://lnweb18.worldbank.org/news/pressrelease.nsf/673fa6c5a2d50a67852565e200692a79/81e7fb4c3d8bba3f85256b660067b411?OpenDocument>
3. Unofficial estimates by WSSCC, in Report of the World Panel on Financing Water Infrastructure, "Financing Water for All", 2003.
4. Averous, L., "Financing Water Infrastructure: World Water Panel", Lehman Brothers, 2002, in Report of the World Panel on Financing Water Infrastructure, "Financing Water for All", 2003.
5. "Vision 21: A Shared Vision for Hygiene, Sanitation and Water Supply and a Framework for Action." P. iii & 28. , also the "Water for People" Component in the World Water Vision presented at the Hague conference in March 2000. <http://www.wsscc.org/vision21/wwf/vision21.pdf>
6. GWP, "Towards Water Security: A Framework for Action," p. 73. 2000. <http://www.gwpforum.org/gwp/library/sec3b.pdf>
7. Price Waterhouse Coopers, "Water: A world financial issue", p. 18. March 2001. http://www.pwcglobal.com/fr/pwc_pdf/pwc_etude_uk-water.pdf
8. Jamal Saghir presentation, World Bank Water Week (May 2002).

TABLE A3 - Current and Future Funding Requirements for WSS, Sector Breakdown

<i>Source</i>	<i>Sector</i>	<i>Current Amount/year (US\$ billions)</i>	<i>Percentage of Total</i>	<i>Future Amount/year (US\$ billions)</i>	<i>Percentage of Total</i>
(1) Vision 21	Agriculture	N/A	N/A	30	16%
	Environment & Industry	N/A	N/A	75	42%
	W&S	N/A	N/A	75	42%
	Total	N/A	N/A	180	100%
(2) Briscoe, John	Irrigation & Drainage	15	23%	N/A	N/A
	W&S	25	38%	N/A	N/A
	Hydropower	25	38%	N/A	N/A
	Water Resources Management	N/A	N/A	N/A	N/A
	Total	65	100%	N/A	N/A
(3) World Bank's Current Commitments	Urban W&S	4.8	29%	N/A	N/A
	Rural W&S	1.7	10%	N/A	N/A
	Irrigation & Drainage	5.4	33%	N/A	N/A
	Hydropower	1.7	10%	N/A	N/A
	Water related Environmental Projects	3.0	18%	N/A	N/A
	Total	16.6	100%	N/A	N/A
(4) Global Water Partnership Framework for Action	Drinking water	13	17%	13	7%
	Sanitation	1	1%	17	9%
	Municipal waste	14	19%	70	39%
	Industrial effluent	7	9%	30	17%
	Agriculture	32.5	43%	40	22%
	Environmental Protection	7.5	10%	10	6%
	Total	75	100%	180	100%

Sources:

1. Vision 21 estimates as cited by World Water Council Newsletter Issue no. 2/2002-March. http://www.worldwatercouncil.org/download/WWC_Newsletter11.pdf
2. Current estimates from Briscoe, John. "The Changing Face of Water Infrastructure Financing in Developing Countries," International Journal of Water Resources Development. September, 1999. Based on 1996 figures. [http://lnweb18.worldbank.org/essd/essd.nsf/a95275735facede4852569970057eeb2/bee47c61be53f8e285256998005cc8e0/\\$FILE/ijwrdfinal1.doc](http://lnweb18.worldbank.org/essd/essd.nsf/a95275735facede4852569970057eeb2/bee47c61be53f8e285256998005cc8e0/$FILE/ijwrdfinal1.doc),
3. Current outstanding World Bank Commitments. World Bank Issue Brief: Water. <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20040985~menuPK:34480~pagePK:34370~theSitePK:4607,00.html>
4. GWP, "Towards Water Security: A Framework for Action," p. 76. 2000. <http://www.gwpforum.org/gwp/library/sec3b.pdf>

Annex B

Guidance on how to
develop regional financial
strategies for the EUWI

The objective of this Guidance Note is to provide practical guidance for the development of regional financial strategies for the EU Water Initiative.

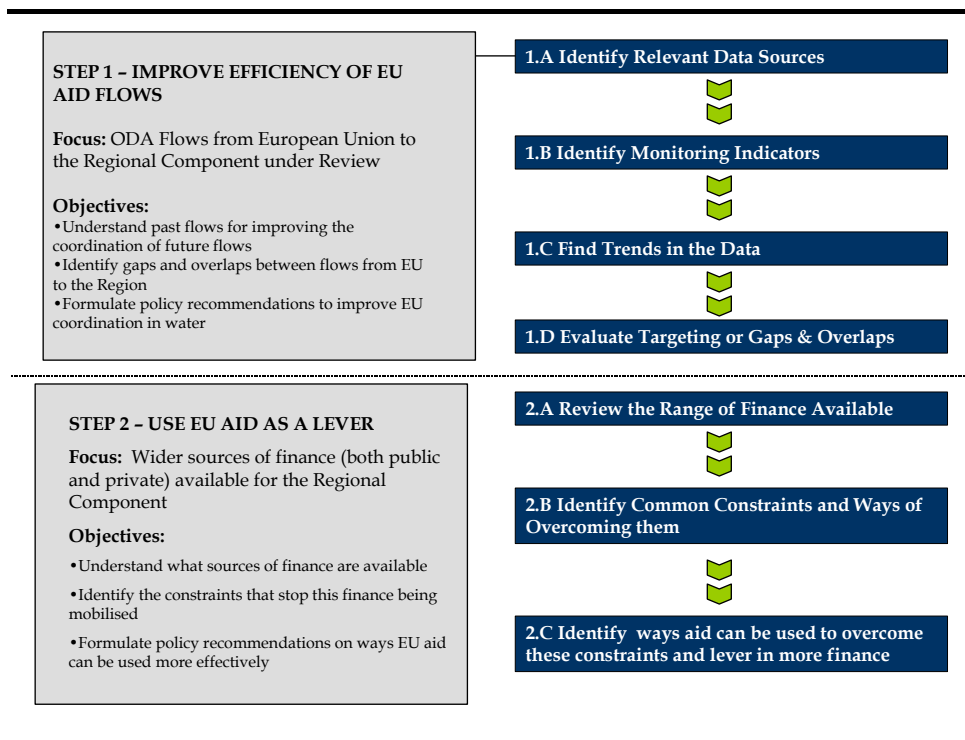
This *Guidance Note* details the steps that were taken to develop our analysis applied to the Sub-Saharan Africa component. This research was carried out on the basis of existing databases and sources that we identified and with considerable inputs from the Finance Working Group members.

The aim of this document is to provide practical information that could be used by other regional components when conducting analysis that could form the basis for recommendations to policy makers and partners of the EU initiative. It has been prepared on the understanding that while different regions have unique characteristics, a basic level of coordination is necessary in order to ensure comparability of results across regions over time.

This information has been gathered there in order to save the regional components from having to “reinvent the wheel” when carrying out the financial analysis.

This *Guidance Note* works through the steps that the finance component followed in conducting this analysis and which are summarised in the figure below. Each step consists of conducting analysis that can support recommendations on two key items of the initiative: improving the efficiency of EU aid flows and using those flows as a lever for other forms of finance.

Box 1.1 *Recommended Steps for Conducting the Regional Analysis*



B2.1

RATIONALE

The objective of Step 1 is to develop analysis that can support the identification of gaps and overlaps in the allocation of EU international assistance to a given regional component.

The analytical steps delineated below were developed based on our analysis of the Sub-Saharan Africa regional component:

- *Step 1A:* Identify relevant sources of data;
- *Step 1B:* Identify indicators for monitoring and evaluation against stated targets;
- *Step 1C:* Find trends in the data;
- *Step 1D:* Evaluate targeting of EU aid programmes by identifying gaps and overlaps.

In each of these steps discussed below, some policy considerations, as well as some practical tips about “how we did it” are provided in separate boxes.

B2.2

THE FOUR STEPS

STEP 1.A

IDENTIFY RELEVANT DATA SOURCES

The first important step is to identify sources of data for the analysis of financial flows to the water sector in the regional component. Even though the focus of the analysis may be on international assistance originating from the European Union, it is important to seek data on all types of financial flows, in order to put such EU flows into perspective and get a real sense of where gaps (or overlaps) may be at play.

Some general data sources are available and are presented for each main type of financial flows in *Annex C (Information Sheet C2)*. In each regional component, more specific sources of information should be sought, especially for those type of financial flows (such as those domestic public finance, or NGO flows) on which aggregated data or even indicators are less forthcoming. *Information Sheet C2* provides indications about where such data may be obtained at a country or regional level.

How we did it: Practical Tips

We first categorised the types of flows that are generally associated with the water sector. These are:

- User charges and household and community investments
- Domestic public financing;
- Overseas Development Assistance (ODA) loans and grants;

<ul style="list-style-type: none"> • Private sector investment from either international or local operators; • Donations from the local and international non-profit sector. <p>Through desk-based research, we learned that 68% of the water sector in Sub-Saharan Africa relies on external aid. This implies that ODA has a substantial role to play in developing the sector, potentially a greater role than in other regions, such as the EECCA, where preliminary research indicated that a greater percentage of funds come from users and domestic public finance.</p> <p>The sources of data we found to be most relevant were:</p> <ul style="list-style-type: none"> • OECD DAC and CRS databases; • The World Bank Private Participation in Infrastructure (PPI) database.

The following box describes potential issues that may arise as a result of searching for relevant sources of data in other Regional Components. Guidance is provided in the form of suggestions that may or may not be relevant to a particular sub-Component of the EU Water Initiative.

ISSUE:	<i>Quickly determining relevant sources of data</i>
GUIDANCE:	<ul style="list-style-type: none"> • Research available information about financial flows to the region. • If flows derive mostly from ODA, then the OECD DAC and CRS databases are highly relevant. • If flows derive from the domestic public sector, then check regional sources of data, such as associations of water service providers, public records, and relevant ministries. • If flows derive from the private sector, flows from the World Bank PPI database may be relevant, as well as other privately developed sources such as banks and private consultancies. • The working group may assist in the process of finding and using sources of data.

ISSUE:	<i>Conducting comprehensive analysis with data from several sources that may not be comparable.</i>
GUIDANCE:	<ul style="list-style-type: none"> • Determine the most important elements for the analysis. If the goal is to help improve coordination, then the big picture is potentially more important than precise details. • Use the working group as a sounding board for ideas, as well as to help clarify the best path forward in the analysis.

STEP 1.B IDENTIFY MONITORING INDICATORS

Identifying monitoring indicators is important in order to assess the performance of past financial flows to the regional component and monitoring the impact that the EU Water Initiative (and other initiatives to meet the Millennium Development Goals) may have in future. However, it is important

to stress that it was not the purpose of the initiative to develop specific indicators, and as discussed in *Annex C (Information Sheet C5)*, ongoing processes outside the EU Water Initiative, and with whom the EU Water Initiative is collaborating, are addressing the challenge of developing relevant indicators.

How we did it: Practical Tips

In order to consider indicators for Sub-Saharan Africa, we considered what already exists with regard to the Millennium Development Goals as a logical first step. As discussed in *Annex C (Information Sheet C5)*, access levels to water and sanitation in urban and rural areas as calculated by the WHO/UNICEF Joint Monitoring Program are currently used as a baseline for indicating access rates.

While access data is available for 2000, we used the data from 1990 for a few reasons: firstly, the data for 2000 was not as comprehensive as that for 1990; and perhaps more importantly, we did not want to use 2000 access data in order to assess the targeting of aid flows that took place between 1997-2001 had an impact on accessibility for 2000. This is not to say that the 1990 data was ideal: by using access data prior to 1997, we were then comparing allocation of funding to the water sector from EU Member States and the EU with historic levels of access prior to the review under review for flows. An alternative would have been to measure funding flows from 1991-2001 against 1990 access rates, to determine whether flows went to those areas in greatest need. However, due to the evolution of thinking in development strategies and policies, we determined to focus on flows from 1997-2001, and accept the 1990 data's limitations.

Given the close similarity between the MDGs and the EU Water Initiative, it made sense to align with the MDG process, as well as their indicators for monitoring and effectiveness. The Millennium Development Project hosts a website with information about country performance against targets and other information about indicators, monitoring, and effectiveness (<http://www.undp.org/mdg/countryreports.html>).

Unlike the WHO/UNICEF data on access rates, similar straightforward and existing indicators are currently unavailable for Integrated Water Resources Management, although a few of the MDGs, such as the goals for Environmental Sustainability and Food Security may be a potential source for indicators in the future.

Issues and Guidance

The following boxes describe potential issues that may arise as a result of considering indicators for monitoring and evaluation.

ISSUE:	<i>Indicators for assessing performance against targets (access, IWRM, water efficiency plans) are not well developed.</i>
GUIDANCE:	<ul style="list-style-type: none"> • At these early stages of the EU Water Initiative, it should be noted that the regional components should closely monitor the development of new indicators, either at a global level such as the Millennium Development Project that is looking to improve upon the WHO/UNICEF data or ongoing work by the OECD to improve its indicators and categories in the water sector, or through a specific regional initiative that might match the goals of the EU Water Initiative (see <i>Annex D</i>). • At a regional level, the EU WI Regional Component might consider using information on access gleaned from sources such as Project Appraisal

	<p>Documents from the World Bank for a given country. Generally these will reflect national statistics rather than the methodology used in calculating the Global Water Assessment.</p> <ul style="list-style-type: none"> Depending on the policies within the region, more information about IWRM may be available, and building blocks may exist for IWRM (for example, in EECCA, as a result of the EU Water Framework Directive, more attention has been and will be paid in upcoming years to IWRM).
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STEP 1.C FINDING TRENDS IN THE DATA

This third sub-step is where attention is focused on finding trends in the data on past financial flows to the region in order to answer the following type of basic questions:

- What is the significance of international assistance for water in the region?
- What types of international assistance is provided to the region?
- What is the share of flows originating from the European Union in those flows of international assistance?
- What are other types of financial flows to the water sector in the region? Which countries are other flows targeting and how does that compare with the countries targeted by international assistance?
- Which European Union member states are providing international assistance to the region and how has their contribution evolved over time?
- What are the main characteristics of international assistance flows from the European Union to the region: in terms of sub-sector distribution, tying status, breakdown by type instrument (mostly grants and loans)?
- Which countries within the region are receiving international assistance from which European Union members?

As most of this analysis was based on using data from the OECD/DAC database, we invested considerable effort in understanding how this database is operating and how the data obtained from that database can be used. This information is reflected in *Annex C (Information Sheets C3 and C6)* and should be referred to in order to ensure the consistency of definitions, such as:

- The definition of the categories of projects included in the “water sector”;
- The definition of flows originating from the European Union;
- The use of other information in the database, such as policy markers or tying status.

Using these definitions will require some interaction with the OECD DAC secretariat, as it involves retreating the data. However, as the OECD was involved in the preparation of these documents, they should be familiar with the methodology put forward and this should speed up such process.

Practical Tip: Using Five-Year Moving Averages

As the data used in the identification of trends is largely historical, it was important to determine whether to use point data or averaged data, and if the latter, to determine over which period averages should be done. Following consultation with the OECD, we determined to analyse most of the data based on a five-year moving average. The

main reason for this is that flows are recorded in the OECD/DAC database based on initial commitments, even if the proposed commitment is anticipated as a multi-year program. This can cause the data to fluctuate, indicating erratic aid flows over time when in fact investment might be quite regular. Hence, averaging commitments over five years better captures the funding cycles of donors.

We present practical guidance for addressing each of these questions in the following sections and highlight some practical tips for doing the analysis as well as potential policy implications from the analysis that we carried out for Sub-Saharan Africa.

What is the significance of international assistance for water in the region?

Our first analysis sought to assess the significance of international assistance to the water sector in the region by focusing on trends. There are various ways of doing so and of putting international assistance into context and this can include examining the total amount of funding going to the water sector in the region by type of funding (along the lines of *Figure 2.1* in the main text).

One particular focus was to assess the amount of ODA that went to Sub-Saharan Africa overall, between 1990-2001, and the percentage of this that went to water. For this analysis we did not use a five-year moving average, as the fluctuations are more likely to be smoothed out when all countries are included and we sought to represent fluctuations in commitments as an indication of the policy commitment to the sector (see *Figure 2.1*).

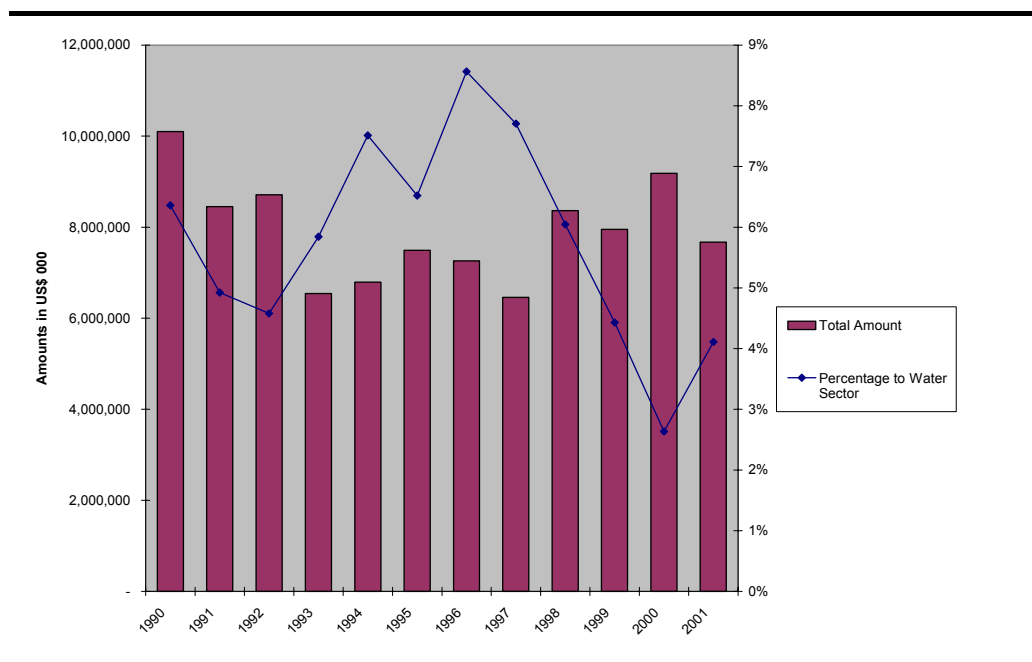
How we did it: Practical Tips

First, we ran a query on the OECD's IDS website that captured total flows to Sub-Saharan Africa between 1990-2001, and then a separate query on total flows to the water sector in Sub-Saharan Africa. We then tallied the percentage of flows to water from the total, and plotted these on an Excel chart.

Analysis and Policy Implications

As shown in the graph, the percentage of ODA has remained under 10%, and is on a downward trend, since 1997. The consistently low profile of the water sector relative to other development concerns, as well as the downward trend implies that despite the increased attention paid to the water sector and an increased awareness of need, the water sector is not attracting needed funds.

Figure 2.1 Total Flows from all DAC Countries to Sub-Saharan Africa and Percentage to Water Sector, 1990-2001



Source: OECD CRS Database, 2003

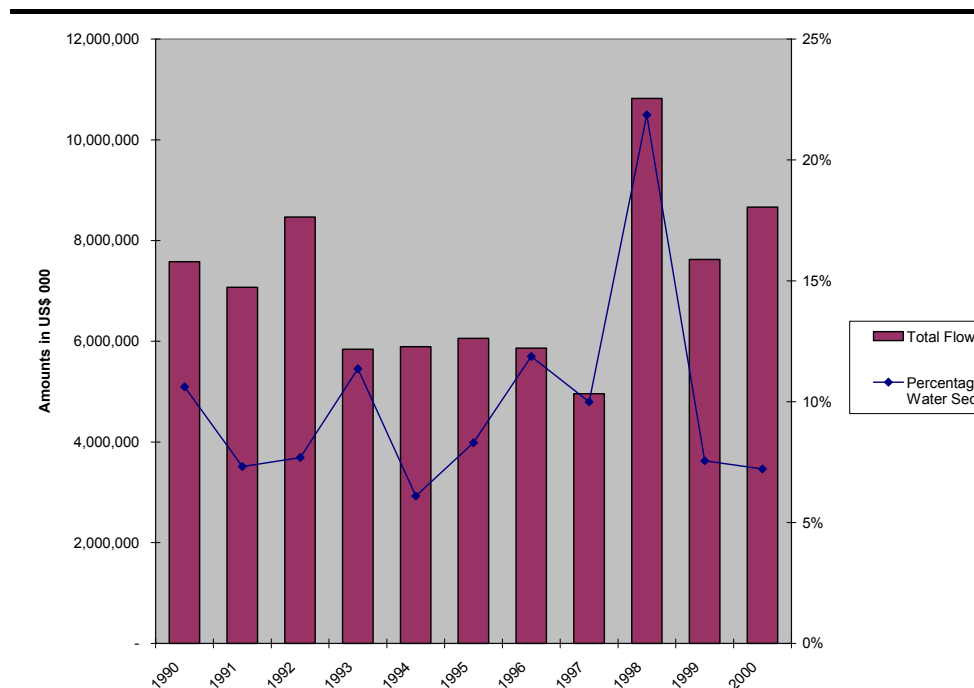
What is the share of the flows originating from the European Union in those flows of international assistance?

In order to identify the share of flows from the European Union, we ran a graph on the total amount of ODA from the EU (including the EC-EDF) from 1990-2001 (again, using straight figures and not the five-year moving average), along with the percentage dedicated to the water sector. This graph is represented in Figure 2.2.

How we did it: Practical Tips

Using the same method as in the previous chart, here we queried only EU Member States and the EC from the DAC, in terms of total flows and flows to the water sector. We then ran a similar chart as in Figure 2.1.

Figure 2.2 *Total Flows from EU Member States and the EC (EIB/EDF) to SSA and Percentage to Water Sector, 1990-2001.*



Source: OECD CRS Database, 2003

Analysis and Policy Implications

The percentage of ODA allocated to the water sector in Sub-Saharan Africa mirrors the global trend of decline. That EU Member States and the EC's donor trends are similar to global trends should not be a surprise; however it does highlight the potential importance of the EU Water Initiative – in the absence of increased funding – to improve upon the nature of how it provides ODA, and the efficiency in the manner in which it is delivered.

What are other types of financial flows to the region?

Data on other types of flows was relatively patchy for Sub-Saharan Africa, even though we identified a number of sources that provided valuable information. These sources and results are detailed below.

Domestic Public Funding

African countries spend less on water and sanitation than the global average, and tend more towards 1 percent, with sanitation's share either abysmally low or non-existent.⁽¹⁾ Possible reasons for this include:

- An abundance of external donors and initiatives that compete to provide low-cost water services, and that operate in a weak institutional environment;

(1) Water Supply and Sanitation in PRSP Initiatives: A Desk Review of Emerging Experiences in Sub-Saharan Africa (SSA). 2002. Water and Sanitation Program. Nairobi, Kenya.

- Other pressing demands on public budgets, including health and education, for limited resources;
- Heavy debt loads: some African governments spend up to 60% of their national budget on foreign debt service payments.

Of the public spending that does occur, the bulk is for more development rather than for recurring costs. User fees are not enough to cover recurring costs, either: although cost recovery through user finance has been successful in some areas in Africa, this success has been limited. This implies that the structure of funding the water sector is generally unsustainable: new funding continues to support new projects, while older projects lack the means to maintain and support themselves.

International Private Sector

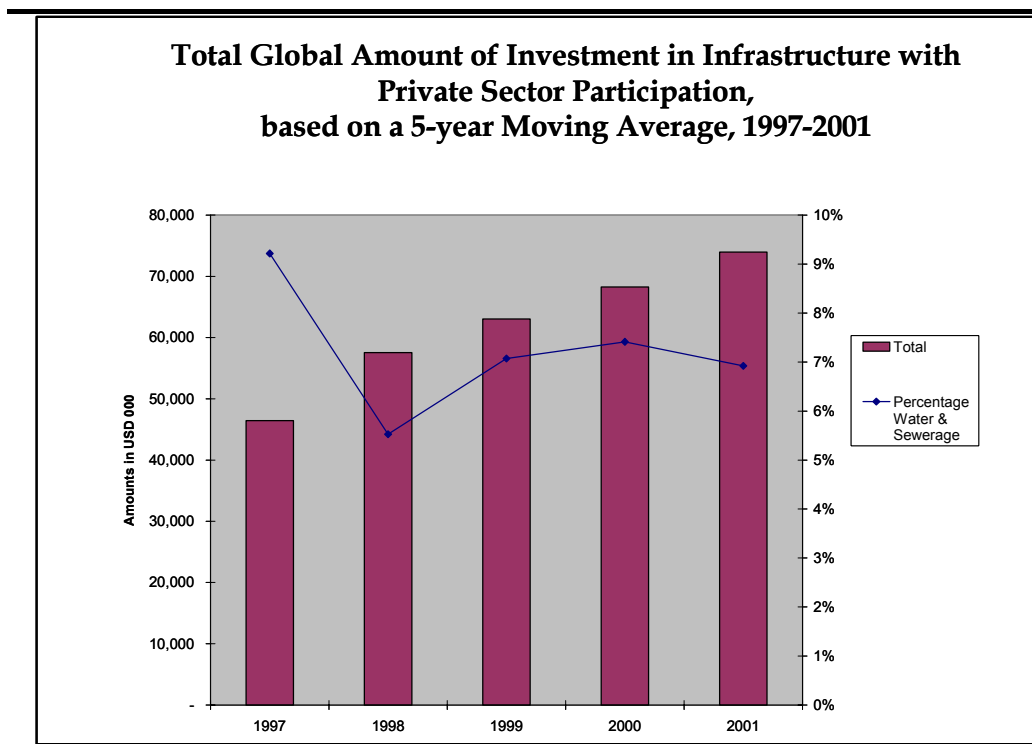
Although the private sector does not provide a great deal of investment in Sub-Saharan Africa, the private sector may provide a means to improve access to water supply and sanitation, or to improve on IWRM. As such it is important to recognise the existing role of the private sector at the regional level. Unfortunately, information about the private sector in Sub-Saharan Africa is difficult to find, as it is often proprietary in nature (from the private sector perspective), or it does not exist.

In deciding the best option for data, we concluded that Sub-Saharan Africa likely would not have international private sector operators without World Bank involvement, and therefore the World Bank's Private Participation in Infrastructure database would be the best source for uniform data on the subject. First, however, we were interested in the global trends in investment against investment in water supply and sewerage infrastructure, in order to observe the "big picture". This is presented in *Figure 2.3*.

How we did it

The PPI database provides information on private investment in infrastructure based on region and based on sector. For *Figure 2.3*, we created a spreadsheet with numbers about total flows from the PPI database (we are grateful to the PPI team in Washington, D.C. for their help in accessing the database) and then broke out each sector by percentage. We calculated a 5-year moving average so as to be consistent with the rest of our data analysis, and plotted the percentage to the water sector against total flows.

Figure 2.2 Total Global amount of Investment in Infrastructure with Private Sector Participation, based on a 5-year Moving Average, 1997-2001

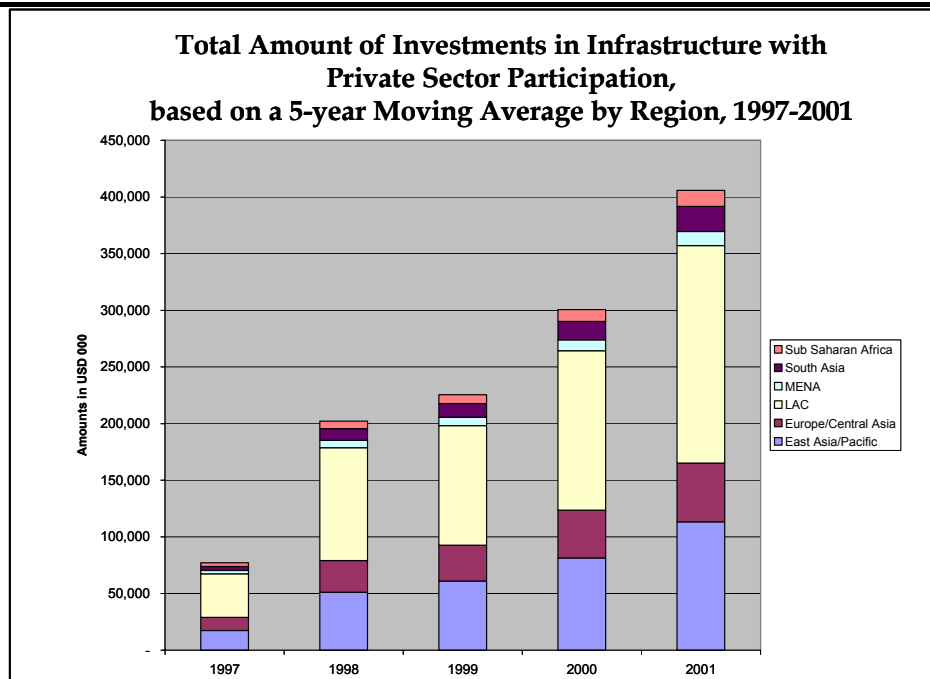


Source: PPI Database, 2003

This chart shows that private sector participation (PSP), much like the trends in ODA, remains at under 10% of the total investment for other infrastructure sectors. The increase in PSP between 1998-2000 represents the increased number of projects that were let as part of larger restructuring and privatisation packages throughout the developing world; more recently, large-scale PSP has fallen out of favour given the many problems with several of those more high-profile contracts, in addition to the state of the large-scale international water companies, which became burdened with debt after their late 1990s buying-sprees.

Figure 2.4 provides a picture of the total amount of investments in infrastructure with PSP based on a 5 year moving average by region, 1997-2001. While this figure does not show data specific to the water sector, it is important to see where Sub-Saharan Africa places in relationship with other regions.

Figure 2.4 *Total amount of Investments in infrastructure with Private Sector Participation, based on a 5-year moving Average by Region, 1997-2001*



Source: PPI Database, 2003

As seen in the figure above, Sub-Saharan Africa received the least investment, although it did slightly increase (on average) between 1999-2001. This chart is particularly useful as it provides a visual of the relative importance of understanding private sector flows among the different regions covered by the EU Water Initiative. Here, East Asia/Pacific; Europe/Central Asia; and Latin America/Caribbean may require further analysis of private sector flows for their analyses.

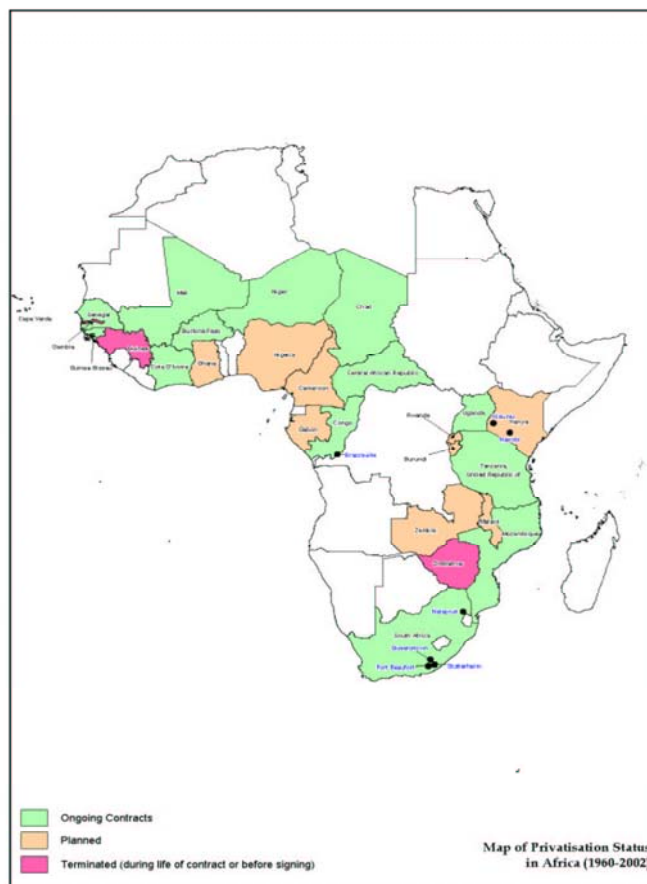
To get another perspective on private sector participation in Sub-Saharan Africa, we also considered the success of private sector participation contracts in Sub-Saharan Africa, as a means to understand the investment climate, and potentially whether partnerships have been successful.

Figure 2.5 provides a map showing where in Africa private sector participation has been used as a means to improve the water sector, and whether these contracts have been successful, or terminated.

How we did it:

We obtained data on the status of transactions that involve private sector participation in Sub-Saharan Africa and created categories of status, depending on whether there was an ongoing PSP contract, a contract was planned or a contract had been terminated (either before or after signing). Countries left in blank are those where PSP transactions have not been explicitly mentioned in a significant manner.

Figure 2.5 *Distribution and Status of PSP in Sub-Saharan Africa*



Source: Compiled from PSIRU, "Water Privatisation in Sub-Saharan Africa: Progress, Problems, and Policy Implications", December 2002.

From this we can see that the use of contracts for private sector participation in water services has been implemented throughout west Africa, in addition to eastern and Southern Africa. Most contracts are ongoing, and more private sector participation is anticipated for several more countries, including Kenya, Uganda, Burundi, Zambia, Malawi, Nigeria, Cameroon, Ghana, and Gabon.

Analysis and Policy Implications

An ongoing debate over the use of private sector participation in the water sector has tended towards whether to use the private sector or not. We propose moving beyond the debate to consider how to best use the private sector in Sub-Saharan Africa despite the risks and challenges due to institutional and regulatory weakness. While the bulk of large contracts in the late 1990s tended to be concessionary, innovative means to attract private sector investment – while maintaining the public nature of the water sector, may be a way to improve the effectiveness of aid flows currently allocated to the water sector in Sub-Saharan Africa.

Other Flows

While we were conducting this analysis, we attempted to obtain comprehensive data about NGO and private sector flows to Sub-Saharan Africa. Unfortunately, we were unable to obtain sufficient data on these two sectors to make estimations.

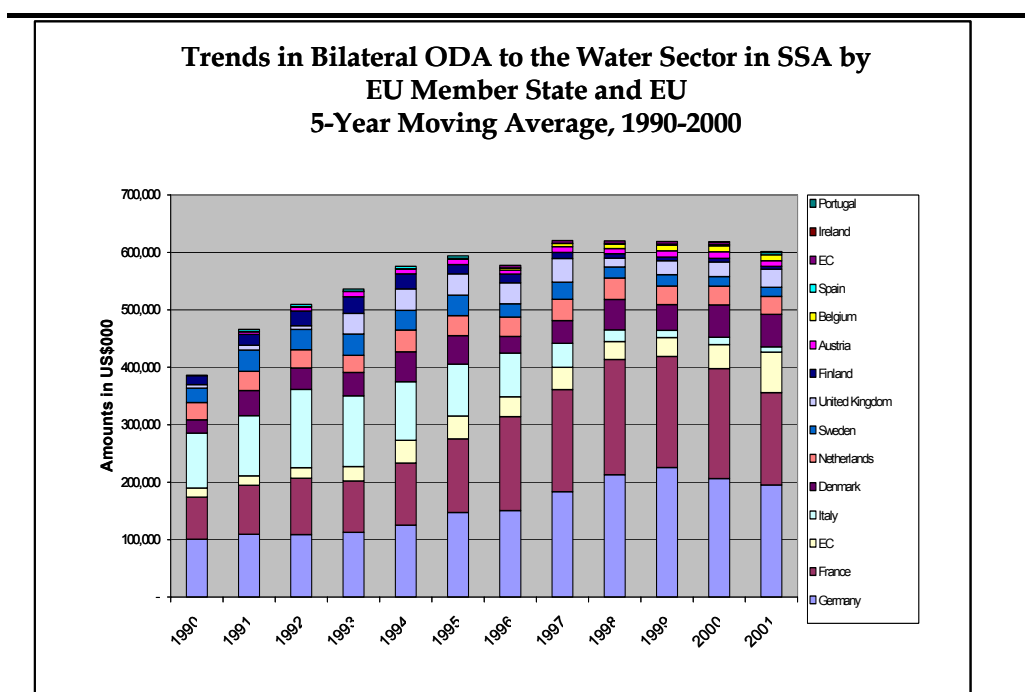
Which European Union member states or institutions are providing international assistance to the region and how has their contribution evolved?

After getting a sense of the “big picture” we wanted to get a better understanding about aid flows from individual EU Member States in Sub-Saharan Africa.

How we did it:

To calculate bilateral aid to Sub-Saharan Africa, we filtered the data provided to us by the OECD by each year, and by each country. We then calculated a 5-year moving average in order to smooth the results. From this we were able to create an Excel graph for the years 1990-2001. This is presented in *Figure 2.5*.

Figure 2.6 *Trends in Bilateral ODA to the Water Sector in SSA by EU Member State and EU 5-year Moving Average, 1990-2000*



Source: OECD DAC/CRS Databases, 2002.

Using a 5-year moving average to reflect trends in ODA more accurately, the graph above shows that while funding for water increased in the 1990s as a result of the emphasis on the water sector during the Water Decade, funding has become to level out and even decline in the latter years of the 1990s and into 2001.

Among the donors represented in this analysis, Germany has been one of the largest and most consistent donors, along with France. On average these two countries have comprised nearly half of all funding from the EU Member States, including the EU (EIB/EDF) since 1990. Italy provided a great deal of funding to Sub-Saharan Africa in the early 1990s, however their contributions have since tapered off. Denmark’s contribution has remained consistent throughout this time period, while Belgium’s role increased in the latter years

of the 1990s and into 2001. Contributions from the EU (EIB/EDF) have grown since 1990, and expanded somewhat between 2000 and 2001.

Based on this analysis, it does not appear that reductions in aid from EU member states have been counter-balanced by an increase in combined EU programmes.

Analysis and Policy Implications

Through the improved coordination and targeting of aid flows, it will be important to build upon the activities of those EU Member States that are already active and have considerable programmes within various countries throughout Sub-Saharan Africa. Potentially those countries providing the largest amounts of loan and grant ODA (e.g., Germany, France, Netherlands, the United Kingdom, and Sweden) could become key countries for building a forum to identify targeted areas and coordinate flows.

What are the main characteristics of EU aid flows to water in the region?

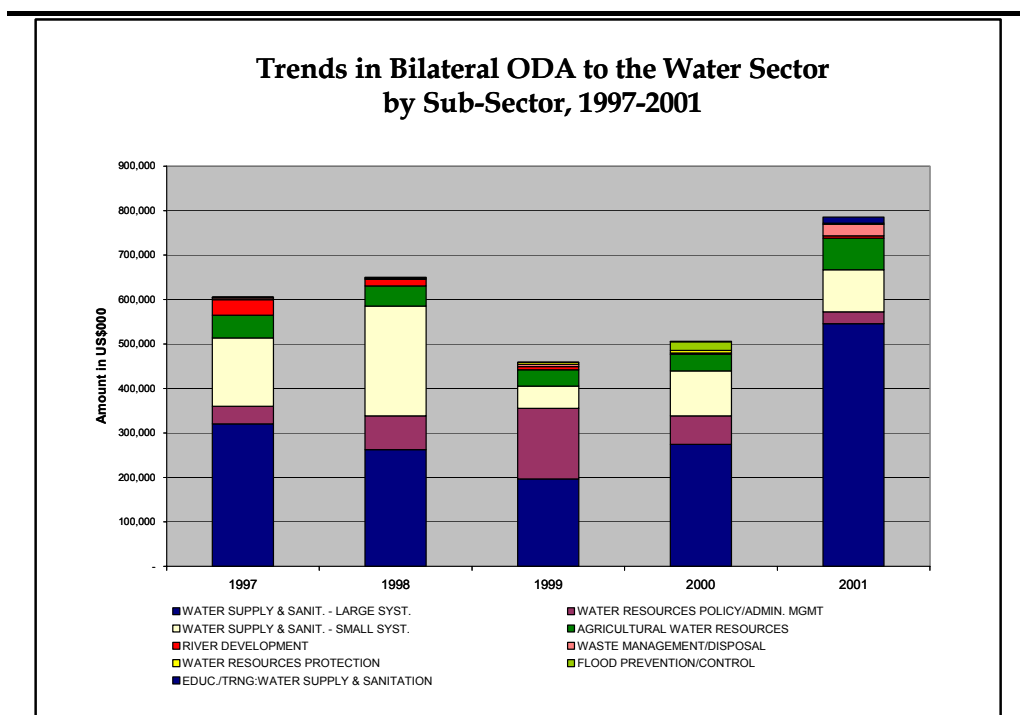
Sub-sector distribution

While assessing general trends in funding to the water sector is important, it is also critical to determine the total amount of ODA flows provided within the sector to different sub-sectors, based on our definition as described in *Annex C Information Sheet C3*. This is provided in *Figure 2.7*.

How we did it:

For this graph, we used the OECD data to filter the different sub-sectors by year, and then ran an Excel graph to show trends in bilateral aid between 1997-2001. We decided not to use a 5-year moving average in this figure, as we were more interested in getting a sense of where funding was going in absolute terms.

Figure 2.7 Trends in Bilateral ODA to the Water Sector by Sub-Sector, 1997-2001



Source: OECD DAC/CRS databases

From this we can see that the bulk of ODA flows go to large-scale water supply and sanitation systems. There was a large increase between 2000 and 2001 for large-scale systems, while funding for water resources policy and management was on the decline. Funding for agricultural water resources is on the rise, slightly, and 2000 saw a relatively large boost to flood prevention/control; River development has almost disappeared, and while waste management was on the decline through 2000, this sub-sector witnessed an increase in 2001.

The deep fall in funding for small systems does not seem as marked in this 5 year analysis, although funding is down from its height in 1998, which seems to be in opposition to the increased emphasis on rural water schemes over this time period. Education and training, which emerged in 2000 as a sub-sector, saw increased attention in 2001. Overall, relative to the other sub-sectors, water resources management has received very little funding.

Analysis and Policy Implications

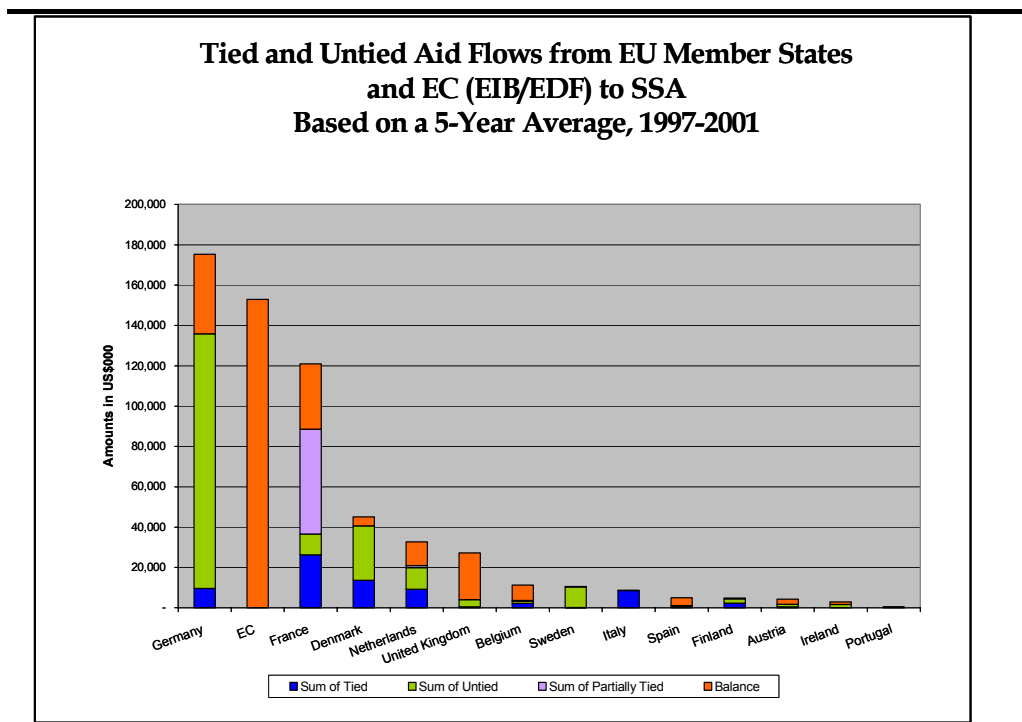
The analysis of where within the water sector funding is allocated is important in that it can show potential disconnects and/or harmonisation of actual funding with stated policy priorities. In the graph above, the large emphasis on large-scale water supply and sanitation projects generally reflects the loan investments made by France and Germany into large-scale water supply and sanitation projects. It could also be a reflection of the difference in costs between large-scale infrastructure and smaller-scale policy and rural development schemes. However, when considered with the bigger picture of funding, a policy consideration may be to increase the amount of funding in areas where there are little to no flows, such as water resources management, and find ways to improve the leveraging of private flows from ODA.

Tying Status

Tied aid is an important indicator for the potential to collaborate in determining and allocating aid flows. As is discussed in *Annex C, Information Sheet C2*, the OECD has a system in place for tracking whether aid is tied or not. However, data is not necessarily comprehensive or accurate, as this information is voluntary. As a result it is extremely difficult to track whether or not aid is tied.

Within the EU, there has been a marked effort to reduce the levels of tied aid in development. In *Figure 2.8*, total aid from EU Member States and the EC (EIB/EDF) is broken down into tied, partially tied, untied, and balance. The balance (in orange) reflects the difference between the total amount of aid that was reported, and the total amount that has been identified as tied, partially tied, or untied.

Figure 2.8 *Tied and Untied Aid Flows from EU Member States and EC (EIB/EDF) to SSA Based on a 5-year Average, 1997- 2001*



Source: OECD DAC/CRS database

From this we can see that there is great variance between and among countries with regards to their tied, partially tied, and untied aid. Most interesting is the amount of unidentified aid flows, as represented by the orange. Whereas Italy's aid flows are mostly tied, Sweden's aid flows are mostly untied. Germany has some element of tied aid, although most of it is untied. France has a high proportion of partially tied aid, as is defined in *Annex C*. A cross-check of the database revealed that between 1996-2000, for EU Member States, less than 55% was tied.

Analysis and Policy Implications

From this analysis two general policy considerations are proposed: First, a general recommendation to consider incentives to improve the reporting of tied or untied ODA to the OECD, in order to maintain more accurate records as well as increase efforts to reduce tied aid all together. The second consideration is to build upon the untied aid that already exists within EU Member States as an opportunity to improve communication and coordination of aid flows, both for organising to leverage other forms of finance, and to help target gaps and prevent overlaps in aid delivery.

Breakdown by Type of Instruments: Grant vs. Loans

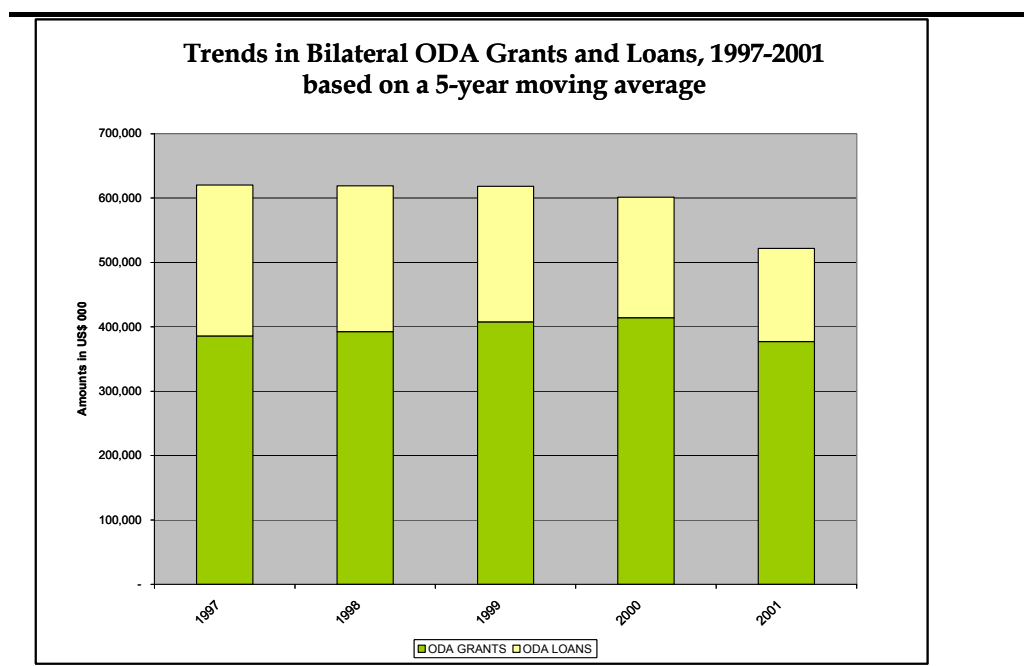
The simple difference between ODA grants and loans are that loans need to be paid back, often with a small rate of interest. In Sub-Saharan Africa, where in many countries over 50% of the national budget is spent paying off debt rather than investing in society implies that grant provision- preferably performance based - may be a more effective means to improve the water sector without burgeoning countries with more debt. Further, loans tend to be provided for

large-scale infrastructure (e.g., treatment systems, dams, large scale irrigation projects) and are provided to national governments, while the current policy environment leans more towards programmatic lending and decentralisation within recipient governments. As such, a look at the relative trends in grant and loan ODA has the potential to demonstrate the linkages between the goals of a policy, and whether it has been implemented by EU Member States. This is provided in *Figure 2.9* below.

How we did it

This graph was created by filtering by year and by the indicator within the dataset as to whether the funding was grant or loan-based. We then ran an Excel chart to visualise the results. Within the data, we conducted some simple analysis of percentages of total, and breakdowns by country in order to present the data below.

Figure 2.9 Grant vs. Loan ODA, 1997-2001



The bulk of ODA financing –72%, to be precise – for the water sector comes from grants, while 28% is derived from loans. Germany and France are the predominant providers of loan ODA. Of the total amount of loans provided between 1997-2001, France provided 58%, while Germany provided 36%. The EC (EIB/EDF) provided 4% of total loans, while Spain, Belgium, and Italy provided 4%, 4%, and <1% respectively. 72% of all the loans provided between 1997-2001 were for large-scale water supply and sanitation.

While 100% of the loans provided by the EC, Belgium, and Italy were for large-scale water supply and sanitation, and 100% of loans from Spain were for water resources protection, France and Germany provided loans to several sub-sectors. The percentages for each country are provided in Table 4.1 below.

Table 2.1 Breakdown of Loan Financing from France and Germany, 1997-2001

<i>SUB-SECTOR</i>	<i>FRANCE</i>	<i>GERMANY</i>
Water Supply & Sanitation - Large Scale	66%	80%
Water Supply & Sanitation - Small Scale	05%	10%
Agricultural Water Resources	13%	06%
River Development	08%	0%
Water Resource Policy/ Admin/ Management	08%	0%
Waste Management/Disposal	0%	03%
<i>Total</i>	<i>100%</i>	<i>100%*</i>

**Figures may not = 100 due to rounding*

Source: OECD DAC Data provided by the OECD.

Which countries within the region are receiving ODA from which European Union member or institution?

Another important element to understanding aid flows to Sub-Saharan Africa is to understand how many donors within the EU provide funding (on average) to each individual Sub-Saharan African country, as well as how many countries receive funding from EU Member States. *Figure 2.10* reveals both the total number of countries that in a sense compete for a total amount of funding from EU Members, and also reveals an indication of the level of coordination required at the country level (see *Box 3.4* in *Annex C*).

analysis was to show preliminary gaps and overlaps in aid by country, meaning seeing which countries have many donors and which have none; however it may also be used as a platform for discussing future collaboration and targeting opportunities.

How we did it:

We created a spreadsheet that indicated each EU Member State and the names of the African countries where they provided funding between 1985-2001, and 1997-2001. We then used a GIS system to generate maps linking each EU Member State to the relevant SSA countries.

Policy Consideration

These charts and maps show in basic terms the layout of aid flows to Africa. Used in conjunction with other information provided throughout this report, such as *Box 3.4* in *Annex C* about the challenge of tracking aid flows in Mali, specific policy considerations may be offered, such as improving the coordination of aid flows at a country level, so that recipient countries have an average of 1 set of paperwork and processes, rather than an average of 5.4. Ideally, recipient countries would be able to have one system for requesting, managing, and reporting on aid flows, which could be consistent with indicators as developed by the Millennium Development Project. Additionally, EU Member States and the EC (EIB/EDF) could potentially increase communication about where they plan to fund projects and programmes, so as to avoid replication of efforts within the same country.

Figure 2.11 Destination of Aid Flows from EU Member States and the EC (EIB/EDF) to Africa

Destination of ODA from Austria to Africa, 1997-2001



Destination of ODA from the Belgium to Africa, 1997-2001



Destination of ODA from Denmark to Africa, 1997-2001



Destination of ODA from Finland to Africa, 1997-2001



Destination of ODA from France to Africa, 1997-2001



Destination of ODA from Germany to Africa, 1997-2001



Destination of ODA from Ireland to Africa, 1997-2001



Destination of ODA from Italy to Africa, 1997-2001



Destination of ODA from the Netherlands to Africa, 1997-2001



Destination of ODA from Portugal to Africa, 1997-2001



Destination of ODA from Spain to Africa, 1997-2001



Destination of ODA from Sweden to Africa, 1997-2001



Destination of ODA from the United Kingdom to Africa, 1997-2001



Destination of ODA from the EC (EDF) to Africa, 1997-2001



STEP 1.D EVALUATING THE TARGETING OF EU AID FLOWS AND GAPS & OVERLAPS

A critical component of determining whether aid flows are effective (or not) requires looking at how well the supply of finance matches existing demand, in order to understand whether the countries most in need receive the right amount of financial assistance.

As a first step, we gathered available data on access rates to water supply and sanitation in urban and rural areas, and considered it as a proxy for “physical needs” in Sub-Saharan Africa: those needs are obviously higher in a country with lower access rates. We then compared this information with available data on the supply of finance. This step is important to understand the potential gaps and overlaps between identified need and existing financial flows, in order to improve coordination and effectiveness of those flows.

Due to the nature of the EU Water Initiative, in that it seeks to rely on existing networks and information, conducting detailed demand surveys in every country throughout Sub-Saharan Africa (or for any other Regional Component) was not feasible. The maps in *Figure 2.12* provide a visual indication of the level of supply to water and sanitation in urban and rural areas throughout Sub-Saharan Africa, as was projected for the year 2000. These access rates are then plotted against our data on funding from the sum of all EU Member States and the EC (EIB/EDF).

How we did it:

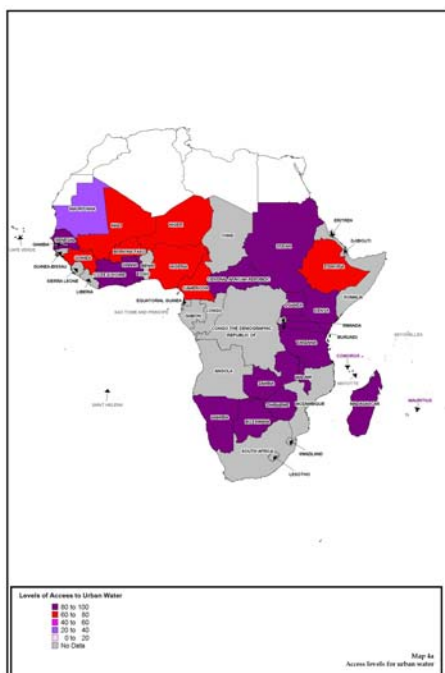
As is discussed in *Annex C*, we chose to use the data that was developed for the WHO/UNICEF Global Water Assessment, which provided information about access rates in urban and rural areas for the years 1990 and 2000.

We assumed that the percentage rates could be used as a crude proxy for demand – e.g., that a country with 45% access rates for sanitation coverage in urban areas had a demand for an increase of 55% in supplying sanitation coverage in urban areas. We assumed that current levels of finance to the water sector were an indicator of the level of supply. As was discussed in *Step 1*, we chose to use the access data for 1990 rather than 2000 because more countries were represented, and also in an effort to prevent an implication of causality between levels of funding and access. As seen in *Figure 2.12*, data from 1990 is compared against data from 2000, to show the difference (if any) in potential demand. To generate the maps, we first grouped access levels into quintiles of 20% each, and then used map-generating software to plot countries with their levels of access.

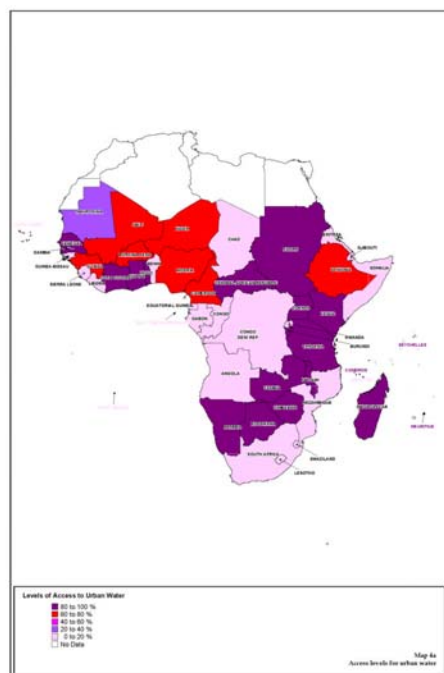
To generate the plot graphs, we created an Excel chart using the access data points for each country matched against the total aid received by that country for the water sector. We then calculated the weighted average of access for each chart, to account for variances in population.

Figure 2.12 Maps of Access Data

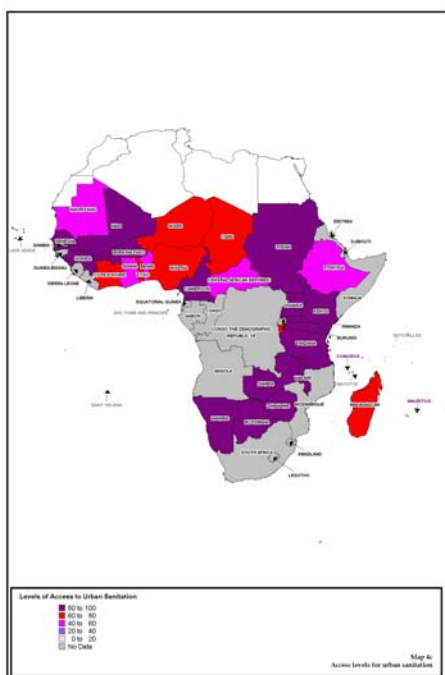
Access to Urban Water Supply, 1990



Access to Urban Water Supply, 2000



Access to Urban Sanitation, 1990

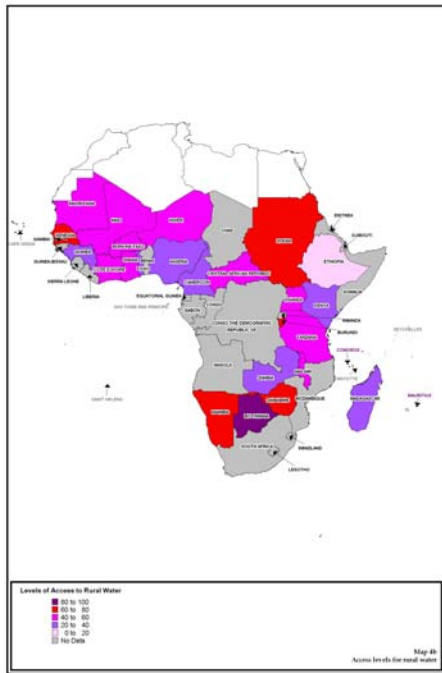


Access to Urban Sanitation, 2000



Source: WHO/UN JMP Global Access Data, 2000

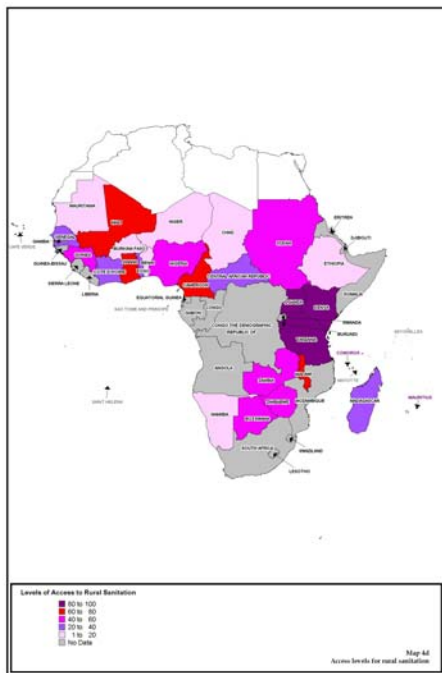
Access to Rural Water Supply, 1990



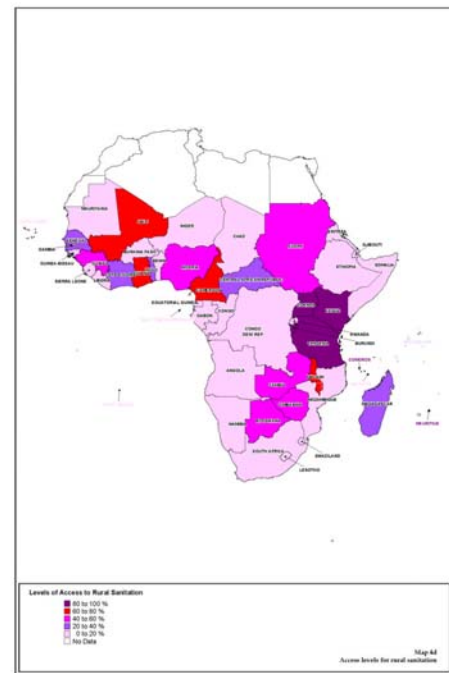
Access to Rural Water Supply, 2000



Access to Rural Sanitation, 1990



Access to Rural Sanitation, 2000

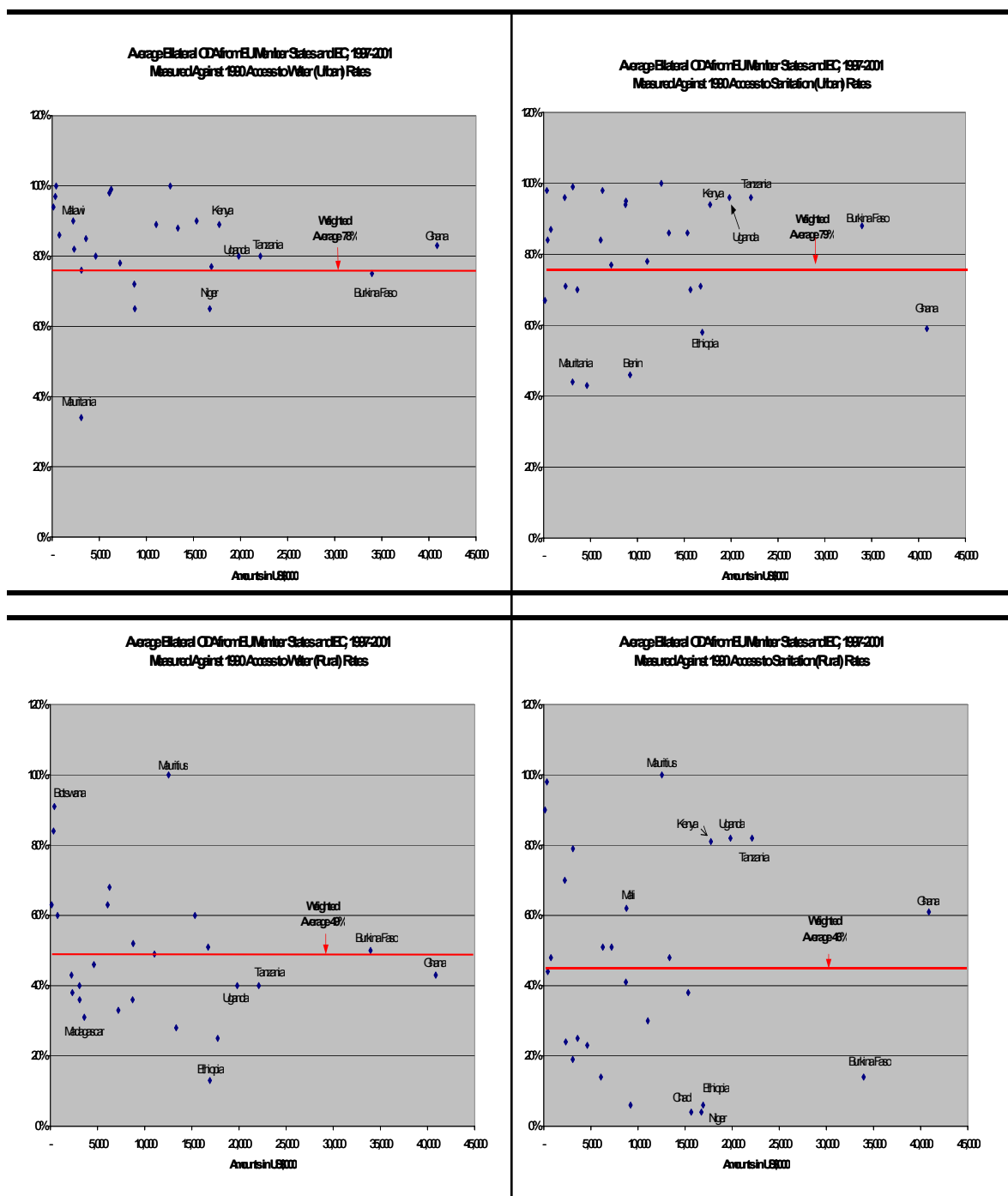


Source: WHO/UN JMP Global Access Data, 2000

From figure 2.12 we can see a wide variance in levels of access throughout Sub-Saharan Africa, although those areas that tend to report high levels of urban access to water supply tend to also have high levels of access to urban sanitation, although access to sanitation rates tend to be lower. Access levels in rural areas are in general lower than for urban areas. Interestingly there is a pocket within East Africa of high levels of access in rural sanitation, and a pocket within Southern Africa (Namibia, Botswana, and Zimbabwe) with higher levels of access to rural water supply. After creating this general picture, we then considered how these access rates matched against average

ODA financing from EU Member States and the EC (EIB/EDF) between 1997-2001. The results are provided in *Figure 2.13*

Figure 2.13 Average ODA financing from EU member States and the EC (EIB/EDF) between 1997-2001.



These plot charts reveal that average ODA funding from the EU Member States and the EC (EIB/EDF) does not follow any particular trend with regards to a sector. Not surprisingly, following the maps in Figure 2.12, the weighted average of access is substantially higher in urban areas, while the difference between water and sanitation for both rural and urban areas is very small. Importantly, these graphs are best read when read together, because the total amount of funding to the water sector is not broken down into an urban/rural; water/sanitation split.

In the plot graphs we matched the names of countries with the outliers; some interesting ones include Ghana, which has above-average levels of access to urban water supply and rural sanitation, with below average levels of access to rural water supply and urban sanitation. Ghana received an average amount of US\$40 million between 1997-2001. On the other end of the spectrum, countries such as Malawi received relatively low levels of funding (an average of under US\$5 million) between 1997-2001 but have high levels of access to urban water supply (90%) and urban sanitation (96%).

These results are intended to be indicative and not the primary basis for determining future aid flows. Rather, they are meant to demonstrate the types of analysis that can be conducted as part of developing the financial component of the Regional strategies.

Policy Considerations:

Matching supply with demand can be difficult given the lack of comprehensive data, as well as politically charged depending on how the information intends to be used. For the EU Water Initiative Financial Component, the intention was to use this information to inform a strategy for improving the efficiency of aid flows, provide guidance on potential areas where coordination might be improved, as well as to help inform where – and how- leveraging of resources might be accomplished.

B2.4

CONCLUSION

Although the steps above may seem straightforward, it required several iterations of analysis, checking with the OECD to be clear on terminology and methodology, and research into the sector to develop. It is hoped that other regional components will be able to take the guidance developed here for their own use, to inform their own processes of analysing trends in the data.

It should be noted that there are no silver bullets in this analysis: determining that some countries receive an abundance of aid while others do not does not mean that there are inherent problems within the aid delivery system. Also, it is not possible to determine an exact amount of funding that will be required to meet the MDGs or the targets of the EU Water Initiative. What these steps and this analysis can provide is additional information about the region, and what the EU Member States are doing in the region, to help inform the process of improving aid effectiveness.

B3.1 RATIONALE - AID CAN BE USED TO LEVERAGE OTHER FORMS OF FINANCE

The financing strategy for the EU Water Initiative had two key objectives.

The first objective was to identify the gaps and overlaps in historic overseas *Step 1* of this Guidance Note explained how this analysis was undertaken.

The second key objective was to assess how those aid flows could be used more effectively. The aim was to look at:

- The wider sources of financing available to the water sector (and the institutions that provide it);
- The constraints that commonly stop this financing being mobilised; and
- Potential ways to use EU aid more effectively to help overcome these constraints and lever more forms of finance into the water sector.

The rationale behind this second step of the analysis was based upon the assumption that aid can also be used to unlock other forms of finance. This can happen by using aid to help alleviate some of the constraints facing wider sources of finance, especially from the private sector, which stop them being attracted to investing in the water sector. The assumption that aid could be used more effectively in this way was a key finding in the final report of the GWP/WWC Panel on Financing Water Infrastructure.

Rather than develop a whole new range of mechanisms for the recommendations that emerged for potential ways to use aid more effectively, the wider initiatives these recommendations could be linked with were listed in *Annex D*. Finally, *Annex E* provided some guidelines on good governance in the water sector, a key area for water sector development where EU aid could be more effectively used and where no explicit initiative was identified.

Consequently, *Step 2* of this Guidance Note explains the process for undertaking the analysis on how aid flows could be used more effectively, which created the material in Section 3 of the report and Annexes D and E.

Our analysis for enhancing the effectiveness of aid flows was undertaken in three stages, 1, 2 and 3.

Stage 1 was to review and discuss the range of wider potential financing options (and the institutions that provide them) for the water sector: what we termed sources of finance and institutional mechanisms for delivery. This was a generic global review.

Stage 2 was to discuss with sector and regional specialists the common constraints that exist in attracting these wider financing sources (and institutional mechanisms) into the water sector. Ways of overcoming these

constraints were also looked at. We used sub Saharan Africa as a case study region.

Stage 3 was an attempt to summarise these issues, particularly from the viewpoint of the three groups of stakeholder who may be most interested in attracting more financial support to the water sector – water users, water service providers and public authorities.

The process for undertaking these three stages is described in greater detail below.

B3.2 THE THREE STAGES FOR INVESTIGATING THE EFFECTIVES OF AID FLOWS

STAGE 2.1 REVIEW THE RANGE OF FINANCING OPTIONS ON OFFER (AND THE INSTITUTIONS THAT PROVIDE THEM)

We identified sources of finance and the institutional mechanisms that provide them in general for the water sector. Some sources were water specific; others were more generally appropriate for infrastructure projects.

We did this at a general level. *Information Sheets D1 and D2 in Annex D* provide a detailed description on each of these financing sources and institutions.

The following table lists the range of sources for raising finance we identified and which may be available. There may be others and this should not be seen as a comprehensive list. We also present key questions, which we asked to help aid discussion about the types of instruments that may be most effective in Africa, the region we chose as a case study

Financial Instruments	
Tariffs and Subsidies	What kinds of tariff and subsidies are available to raise revenues from users? What are the best ways of using user finance to help pay for water projects? What sorts of subsidy can best help? How can aid be used to better leverage more user finance?
Environmental Charges	What sort of environmental charges are useful and against whom can they be levied? What are the institutional challenges in implementing environmental changes? How can aid be used to best develop and stimulate environmental charges? Is this the most effective use of it?
Grants	How are aid grants now being delivered? What are donor priorities? How can grant aid be used most effectively to help support the water sector? By directly funding projects and programmes? Or via discrete pieces of technical assistance? Should aid

	be targeted solely for the very poorest or emergency situations?
Loans	Can soft loans from IFI's or other financing institutions, and PRSC's in particular, be targeted better toward financing water projects? How can aid be best used to help this process? Underwriting risk? Subsidizing costs, especially for low performing water investments? Building capacity?
Mixed Credits/ Export Funds	Can mixed credit mechanisms play an effective role in developing water projects? How would this relate to GATS, for example? Is this the best way to use aid in leverage terms?
Micro credit/finance	Is there a role for community-based financing schemes and micro-credit to help the development of water projects? Is this an effective area to use ODA?
Output based aid	Is the more widespread use of OBA a useful way to attract more finance into the water sector? How might it work?
Bond markets	Are local capital markets a potentially useful source of finance for the water sector? Can aid be used more effectively to help schemes develop local capital markets? Is this an effective route? How viable could it be to use international bond markets to finance the water sector? Is there the potential for developing aggregated loans? Is there a case for aid to be used to support the development of a vehicle to raise funds on the international bond market for aggregated water sector loans?
Debt swaps	Is there a role for debt swaps for water?
Equity	What structures are being developed among donors or IFIS to provide affordably equity finance mechanisms for developing country water operators? Can aid be more effectively used to enhance returns on tariffs or to offset ill-liquidity premiums in order to further enhance interest from equity investors in (public or private) water projects in developing countries?
Direct Private Investment	Rather than concessions and management contracts alone, are there other ways in which direct private investment can be encouraged in the water sector? Can aid be better used to help leverage more private investment into other kinds of lower risk management models for public water authorities?
Public-Private Partnerships, and Private Finance	Do PFI style arrangements provide a form of finance opportunity for stimulating investment in the water sector? Can aid be better used to help stimulate

Initiatives	more PFI style proposals and project?
Voluntary Finance	Can NGO voluntary finance-raising initiatives or remittance flows be used to help raise finance for the water sector?
Sector Wide Approach Programmes	Does the development of SWAPs for water encourage further financing into the sector? Could aid be better used to develop SWAPs?

The Table presents a range of questions that we found difficult to judge or obtain quantitative evidence on. Its strength was in asking specialists to think about the key sources of finance from among them, and the ways in which aid might be better used to enhance their effectiveness.

The list of sources was also discussed within the context of the EU donor family and their emerging strategies for finance and water. As a result of this process, interesting developments were identified, *inter alia*, in the

- Development of various investment facilities to pool risk and sources of funds for equity (EIB, EuropeAid EDF);
- Promotion of multi-donor initiatives to promote more private sector funding into public infrastructure projects, including water (Private Infrastructure Donor Group, Emerging Africa Infrastructure Fund),
- Use of mechanisms to minimise risk (PROBARCO within the AfD, GuarantCo within the PIDG);
- Development and evolution of project preparation facilities (Project Preparation Committee, Africa Water Fund, the PIDG's DevCo); and
- Proposals for sectoral funds for water (EU Water Fund for Africa)

Some of these were regionally specific; several were at the design stage and were consequently evolving in terms of their shape and scope. As a result, there seemed to be plenty of opportunity to engage in how these donor initiatives could be better designed to help provide sources of finance or useful mechanisms to help finance flow into the water sector.

STAGE 2.2 IDENTIFY THE COMMON CONSTRAINTS THAT EXIST IN ATTRACTING THESE WIDER FINANCING SOURCES INTO THE WATER SECTOR.

The next stage of the process was to consider why, despite the range of sources of finance and the different mechanisms and institutions which are offering increased access to finance, there are still problems with attracting these resources to the water sector.

Common constraints to attracting finance to the water sector were debated and discussed with Working Group. In essence we found that the constraints boiled down to four:

- Commercial Risk
- Political Risk/ Poor Water Governance

- Poor Project Preparation
- Lack of Capacity

The following table provides a prompt for discussion, under the heading of each broad constraint, about what the details may consist of.

Commercial Risk	<ul style="list-style-type: none"> • Foreign exchange risk • Contractual risk • Risks in operating water and sanitation businesses • Risks in undertaking capital investment programmes • Risks in construction
Political Risk/ Poor Water Governance	<ul style="list-style-type: none"> • Political interference • Unclear regulatory terms and conditions • Unstable regulatory regime • Inability to enforce payment • Inability to secure tariff reform • Uncertainty over future revenues • Lack of commercial independence for water sector operators • Inability of sub-sovereigns to raise cost-effective finance • Lack of institutional and regulatory harmonisation • Lack of favourable long term debt conditions • Difficulty in mobilising local currency guarantees
Poor Project Preparation	<ul style="list-style-type: none"> • Few or rapidly conceived projects, due to high cost of project preparation • Focus on the capital investment required rather than financial sustainability or commercial viability of the proposal • Lack of suitable clauses to minimise risks to external investors • Too many prestige water sector projects rather than poverty reducing water projects • Less focus on developing commercially sound (aggregated) proposals for small towns, peri-urban and rural areas • Problem of factoring in sectoral (mis)allocation or transboundary issues

Lack of Capacity	<ul style="list-style-type: none"> • Lack of public sector capacity to adapt to new roles and changing responsibilities, both within public water authorities, regulatory bodies and policy makers/ finance officials • Lack of in-country private sector capacity to respond effectively to increased PSP levels • Lack of capacity among civil society to cope with more autonomy in water sector decision making and management • Lack of capacity in all sectors more acute at sub-national levels
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Ways of overcoming these constraints were also discussed and debated at the same time.

Capacity Building was felt to be extremely important and while a range of EU donor agencies may be engaged in the process, there were felt to be no harmonised approaches or clearinghouses to share knowledge and experiences.

However, most attention was given to the constraint that poor water governance offered potential investors in the water sector. The range of problems poor water governance or political risks created for investors and the difficulty of resolving them (as opposed to the solutions that could be devised for mitigating commercial risk, poor project preparation and a lack of capacity) meant that the issue of good governance in the water sector became a major focus of the discussion.

Consequently, much time was devoted to creating some guidelines on what a good water governance framework would look like within a recipient country. They were designed to cover the roles of four key water and finance stakeholders:

- The role of Public Authorities;
- The contribution of Civil Society;
- The contribution of water operators and other service providers; and
- The contribution of financial institutions

Annex E presents these guidelines on Good Water Governance. They are the result of a wide process of consultation. They can be used as a start point of ideas to either judge to what extent the existing political environment fails to shape up, or as a road map in terms of what to reform or aspire to. Importantly, it has to be stressed that these guidelines are for information only. They should not be used as a tool to force change, judge risk or enforce conditionality.

In fact, the discussion on how to identify the constraints of poor water governance and how to reform them, can use these guidelines as a start point, but can also engage with other initiatives that are looking at improving the policy environment for water. These include:

- The GWPs Dialogue on Effective Water Governance. This suggests that governance issues are a prerequisite for the successful implementation of Integrated Water Resources Management. GWP defines water governance as the range of political, social, economic and administrative systems in place to regulate the development and management of water resources and provision of water services at different levels of society, and sets out to enable institutions and institutional arrangements.
- The Water and Sanitation Programme (WSP). The WSP is a worldwide network operating in over 30 countries that works with governments, donor agencies and NGOs to promote solutions and influence policy related to helping poor people gain sustained access to improved water and sanitation services. In Sub Saharan Africa, the WSP Africa programme may be the most relevant building block for addressing policy issues with ODA. WSP-AF has been a regional leader in Africa, supporting countries to develop appropriate WSS-related strategic interventions, including development of WSS policy and reforms, implementation models and strategies and support to investment projects and pilots.

STAGE 2.3 **SUMMARISE THESE ISSUES FROM THE PERSPECTIVE OF KEY STAKEHOLDER GROUPS**

The final stage of the analysis was to provide a summary of the finance sources we identified; the common constraints to their deployment; and some recommendations on how EU aid could be used more effectively to overcome these constraints to leverage the wider sources of finance available.

This analysis can be found in Section 3 of the report.

We created summary tables to present this information. Importantly, we presented the summary tables from two perspectives:

1) The four key groups of water stakeholders who would be interested in making better use of aid financing resources:

- Water users;
- Water service providers; and
- Government at sovereign and sub sovereign levels
- EU aid agencies themselves

2) Within the context of the four sets of constraints identified by the working group

- Commercial Risk
- Political Risk/ Poor Water Governance
- Poor Project Preparation
- Lack of Capacity

In this way we hope to both provide thoughts on alleviating constraints to finance and thoughts on delivering more finance to key water stakeholders.

Importantly, the tables were not designed to be comprehensive, but rather to touch on some of the key issues.

Furthermore, we attempted to link both the possible recommendations for better uses of EU aid and the types of instrument available for providing finance in each of these tables, to key recommendations contained within the Final Report of the World Panel on Financing Water Infrastructure. This report outlined a large number of potential actions that can be taken to improve financing to the water sector; consequently we have attempted to extract a number of those recommendations as they relate to each type of water stakeholder.

B3.3

CONCLUSIONS

We used the process outlined above to explore constraints that were identified as affecting financial flows to the water sector in Sub Saharan Africa. A critical component of the discussion was to discuss ways in which EU ODA could be used to mitigate these constraints and help to leverage other forms of finance.

The following conclusions emerge on using this process:

- A multi-disciplinary working group consisting of representatives from key water stakeholder groups (donors, private sector, IFIS and NOGS) is critical as the sounding board and discussion forum for ideas
- Good Water Governance (or political risk) is the key constraint and is the most difficult and emotive issue to address and provide solutions for.
- The analysis will need an objective steer (a consultant) to draw out key findings from the discussions and present them as summary information.
- An iterative approach is critical. We had three working group meetings and circulated evolving text on several occasions. A full draft final document is required for all to comment on and have a sense of ownership about the findings, and form an adequate basis for policy recommendations.

Annex C

Financial Flows to the Water Sector: Data Sources and Monitoring Indicators

This Annex contains information on general data sources on financial flows to the water sector and outlines potential indicators for assessing the effectiveness of such financial flows.

The objective of this Annex is to help regional components in the identification of data sources and indicators and enable them to use them in a coherent and consistent manner. It is intended to be very practical and to provide a reliable information base for the preparation of the EU WI's regional financial strategies.

The development of this Annex was based on the observation, during the course of the Finance Working Group activities, that some databases, such as the OECD/ DAC database, provide very useful data sources, although they are not always straightforward to use for analysis applied to the water sector. Further, if regional components were to follow the guidance provided in this Annex for their own analysis, this should ensure the comparability of the analysis from one regional component to another. In turn, this should allow for a stronger degree of coherence in the definition of an overall financial strategy that builds on separate strategies developed for each regional component. ⁽¹⁾

Note that this Annex was based on data sources *available* at the time of writing, and will become outdated as new data sources and indicators become available with additional research that could develop on the back of the EU WI and other international initiatives. The section on the "identification of gaps" at the end of each information sheet provides direction for future research based on Working Group discussions. Each section is presented in the form of an "Information Sheet" that can easily be cross-referenced with *Annex B*, the "Guidance Document for Regional Components."

- *Information Sheet C2* provides an overview of available data sources;
- *Information Sheet C3*: presents an easy-to-use guide for using the OECD/ DAC database to track international aid flows to the water sector;
- *Information Sheet C4* presents databases that currently exist to track flows from the private sector, and highlights current gaps in this data;
- *Information Sheet C5* focuses on available indicators for monitoring the impact of financing flows, and also highlights gaps and overlaps;
- *Information Sheet C6* contains a glossary of terms employed by the OECD for analysing aid flows.

(1) Note that this Annex was developed thanks to a close interaction with OECD and World Bank staff, using a focus on Sub-Saharan Africa. As a result, illustrations of issues relating to data sources and indicators tend to focus on this region, although there are just given as examples of what needs to be identified in other regional components.

C2 OVERVIEW OF AVAILABLE DATA SOURCES

C2.1 RATIONALE

This information sheet provides an outline of the available data sources for the main types of financial flows to the water sector.

As mentioned in the main paper, the water sector can be funded by a variety of sources, including:

- User charges and household and community investments;
- Domestic public financing;
- Private sector investment from either international or local operators;
- Official development assistance (ODA) loans and grants; and
- Donations from the local and international non-profit sector.

As a result, data sources on financial flows to the water sector are diverse. No single source can provide details on all of these flows, nor are all of these flows captured in a manner that immediately allows for comparability. While ongoing efforts outside the EU Water Initiative are underway to strengthen sources and availability of data, existing data that is readily available can at best present a snapshot of trends and basic gaps.

C2.1.1 *Primary focus: identifying data sources on international aid flows*

The objective of the analysis to be undertaken as a basis for defining the financial strategy of the EU Water Initiative is not to track every type of flow to the sector from all potential sources in a comprehensive manner. Not only would this be a time-consuming exercise, it also would not likely present any practical results, as a comprehensive analysis would make more sense at a national or sub-national level. Rather, a key objective of the EU WI is to identify trends in international aid flows originating from the European Union and to improve their coordination. For this reason, the primary focus is on the identification of data sources for international aid flows from the EU to the water sector, in order to assess what contribution the EU is currently making on meeting the MDGs for water in each region.

C2.1.2 *Secondary focus: identifying data sources on other types of flows*

At the same time, data on other types of flows is also highly relevant to the EU Water Initiative, for many reasons:

- In some regions or countries, international aid flows may represent a very small portion of financial flows to the water sector, and this portion would be even smaller if the focus is exclusively on flows from the EU. Therefore, other types of flows need to be considered in order to assess the true magnitude of the gap for meeting the MDGs for water and sanitation;

- In addition, one of the purposes of the Initiative is to help foster coordination between the many partners that work in the water sector in different regions. Therefore, when assessing financing gaps with a view to meeting the water sector MDGs, other types of flows need to be considered as well..

C2.2 KEY DATA SOURCES

As different regions have different compositions of funding sources, it is important to be aware that there is no “one size fits all” data source that can be used. *Table 2.1* provides information about the data sources on financial flows to the water sector that were identified during the course of this research, both generally and more specifically for Sub-Saharan Africa, starting with the type of flows at an international level and moving downward to national or sub-national levels

There are a number of “site-specific” data sources. Given that this analysis was meant as guidance for all regional components of the EU WI, very few site-specific data sources were identified for Sub Saharan Africa. Each regional component will have to identify such data sources themselves.

Table C2.1 Available Sources of Data on Financial Flows to the Water Sector

<i>Type of flow</i>	<i>Potential Sources of Data</i>
User charges and household and community investments	<ul style="list-style-type: none"> • Specific information may be available at a country level from NGOs working in the field and/or Development Agencies such as World Bank field offices.
Domestic public finance	<ul style="list-style-type: none"> • National Water Ministries and/or government agencies • Information/ research may be available through PRSP and other development strategies involved in the water sector. The OECD also publishes reports on trends in public expenditures for some countries/ regions, such as in EECCA. In Sub-Saharan Africa, the WSP is conducting ongoing research in this area.
Private sector flows (international or local operators)	<ul style="list-style-type: none"> • World Bank Private Participation in Infrastructure Database • Private sector estimates
ODA loans and grants	<ul style="list-style-type: none"> • OECD DAC and CRS databases
Donations from local and international non-profit sector	<ul style="list-style-type: none"> • Key NGOs working in the region may be a good starting point for general information; generally, strong, uniform data is unavailable.

C2.3 IDENTIFYING GAPS IN AVAILABLE DATA

A major shortcoming with all available data sources is that they only track past financing flows, thereby limiting the usefulness of this data for the determination and the coordination of future policies and programmes.

Information on past financial flows can be useful to estimate future policy needs...

- Donor programmes tend to be relatively stable over time, so the analysis of past spending can be useful to highlight where EU donors are most active, where there are current gaps and overlaps, and where further coordination is required; and
- Information on past spending compared to past performance indicators can provide a basis for assessing the performance of past programmes, although such analysis requires considerable caution (see *Annex F*, “Guidance Document for Regional Components” for further discussion).

Addressing the lack of data on future flows remains a key challenge for the Initiative

- The experience of the Working Group in obtaining information about future programmes via a series of questionnaires was poor: either the information is not readily available for EU Member States themselves, or it may be sensitive and difficult to obtain;
- EU Member States’ methodologies for projecting future flows to the sector are not harmonised and depend on their programming methodologies (i.e. whether programmes or projects are multi-yearly or not, etc.);
- Any further questionnaire could only provide a snapshot of potential future flows; and
- The development of a more comprehensive database on future flows would require an adequate structure that could carry out and coordinate the data collection effort on an on-going basis. Few institutions would have the institutional and financial capacity to do so, unless they were developed for the specific purposes of the EU Water Initiative.

There are no readily available data sources for domestic public flows or user fees, even though these often represent the most substantial amount of funding to the sector

Generally, the bulk of financing for the water sector is provided by the domestic public sector, followed by external aid. The exceptions are those 41 countries classified as heavily indebted poor countries (HIPC), of which 32 are situated in Sub-Saharan Africa, where overseas development assistance provides the majority of financing sources, whether through bilateral aid flows, or through NGOs.⁽¹⁾ Because of the multiplicity of agencies providing funding in many countries, obtaining consolidated data even if tracking it at the country level could be a cumbersome activity.

Information about NGO flows is very limited and fragmented, and there is no comprehensive database tracking such flows to the sector

(1) The WHO/UNICEF Joint Monitoring Programme’s “Global Water Supply and Sanitation Assessment 2000 Report” found that the contribution of external support agencies to average total investments in water were highest in Africa, at 68 percent.

Research into this topic revealed that many NGOs are unable to track their data about aid flows in a way that would be meaningful to the EU Water Initiative, largely because they lack the budgets, either administratively or as part of projects, to do so. The OECD's Development Assistance Committee and Creditor Reporting System databases track NGO flows, but reporting is not sufficiently detailed to separate NGO flows to the water sector from the total. Specific recommendations about how such data could be gathered for international aid and international private flows are provided in *Information Sheets C3* and *C4*, as there are those for which comprehensive databases have been identified.

C3 *TRACKING INTERNATIONAL AID FLOWS TO THE WATER SECTOR: FAQs ABOUT USING THE OECD/DAC DATABASE*

C3.1 *RATIONALE*

This information sheet provides a guide to using the OECD/DAC database for identifying international aid flows to the water sector.⁽¹⁾

The OECD Development Assistance Committee (DAC) compiles consistent data on ODA flows over time for its members: given that all European Union Member States and European institutions channelling aid flows (the European Commission and the European Investment Bank) are DAC members, this database is a prime source of information for tracking aid flows originating from the European Union to the water sector in developing countries. This Information Sheet provides answers to the following questions with respect to using the OECD/ DAC database: ⁽²⁾

- What data does the OECD/DAC database capture and how can I access such data?
- How can I capture ODA and OA flows to the water sector?
- How can I capture flows originating from the European Union and flowing to a given regional component or country?
- What additional information is available in the OECD/DAC database and how can I make use of it for sectoral analysis?

C3.2 *WHAT DATA DOES THE OECD/DAC DATABASE CAPTURE AND HOW CAN I ACCESS IT?*

The OECD DAC collects data on official development assistance (ODA), official aid (OA) and other lending to developing countries and countries in transition. ODA and OA differ on the basis of the type of recipient countries: developing countries (including Sub-Saharan Africa) receive Official Development Assistance (either on a bilateral or multi-lateral basis) while transition countries (including EECCA) receive Official Assistance.

C3.2.1 *Available databases*

The DAC Secretariat compiles data in two distinct (and complementary) databases:

- The *DAC database* provides annual aggregated statistics; and
- The *Creditor Reporting System (CRS)* provides statistics by sub-sector and is therefore the primary source of information when analysing financial flows to the water sector.

(1) Note that a preliminary strategy for collecting information about international aid flows from EU Member States was to send a questionnaire to partners and stakeholders of the EU Water Initiative in July 2002. A further questionnaire was sent out in November 2002. Poor results, both in terms of quantity and quality, revealed that broader sources of data would be required. The focus therefore switched to obtaining data from the OECD/DAC database, which is the most comprehensive database on (past) flows of international development assistance from OECD countries.

(2) Note that these questions were raised during the Working Group sessions and answers should therefore provide useful guidance to other regional components looking to perform a similar analysis.

Most of the OECD DAC data is available on-line, ⁽¹⁾ but more detailed queries may need to be relayed to and treated directly by the OECD/ DAC secretariat. For example, the definition that we developed for the water sector included some categories (see *Section C3.3.2*) that are not generally considered part of the water sector, so specific analyses for the water sector in Sub-Saharan Africa were not possible to query through the website. However, information about total ODA flows to the water sector in general, or data for other donors besides EU Water Initiative partners, is accessible on-line. External users can run online queries on these databases free of charge through the International Development Statistics Online (ISD/o).

Box C3.1 below provides additional details on the linkages between these databases.

Box C3.1 *Linkages between the DAC and the CRS databases, and other databases*

The *DAC database* provides statistical information about the volume, origin, and types of aid and other resource flows to over 180 recipients throughout the world. This includes recipient countries' intake of Official Development Assistance (ODA), Official Assistance (OA), other official flows (OOF), and private funding from members of the DAC, multilateral agencies, and other donors. The DAC database provides information in an aggregated form.

The *CRS database* contains information on individual aid activities, and includes a subset of individual loan and grant commitments from DAC donor countries. Transactions submitted to the CRS database are expected to include detailed financial information about the transaction, including repayment schedule, tying status, and sector allocation in the donor country's currency. These figures are converted into US dollars using annual average exchange rates.

The CRS and the DAC databases were designed to supplement and reinforce one another. The completeness of the CRS data can be verified through comparisons with the aggregated DAC statistics. Conversely, the quality of the DAC statistics – that is, their conformity with definitions and consistency agreed between members – can be analysed through the CRS, which shows the drilled-down figures behind the aggregates.

The CRS is also linked with statistical reporting systems of some international organisations, notably the World Bank. For example, CRS data may be aggregated to yield totals or sub-totals that correspond to data on official loans collected in the World Bank's Debtor Reporting System (DRS). However, it should be noted that not all aid recipients reported in the CRS are World Bank members (and vice-versa), and as such, this linkage only relates to individual countries. Other international organisations may incorporate CRS data on ODA grants and loans into their own databases. A word of caution, however: the definitions, classifications, and country groupings used by other agencies may not correspond to those agreed upon by the DAC.

Source: OECD/DAC. 2002. "Reporting Directives for the CRS." DCD/DAC (2002)21.

C3.2.2 *Types of flows and their characteristics*

As discussed above, the DAC tracks ODA, OA, OOF, and other financial flows. Detailed descriptions of these types of flows are provided in *Table C3.1* below. In addition, a glossary of terms used by the OECD is presented in *Information Sheet C6*.

(1) The websites are :<http://www.oecd.org/dac/stats> for the home page. For a direct link to the database, go to <http://www.oecd.org/htm/M00005000/M00005347.htm> A detailed explanation of the information contained in the CRS system can be found in "Reporting Directives for the Creditor Reporting System" Internet: <http://www.oecd.org/pdf/M00033000/M00033362.pdf>

Table C3.1 *Types of flows tracked in the DAC database*

Type of Resource Flow	Availability
Official Flows	Through Online database
1. Official Development Assistance (ODA) = Concessionary Finance	
1.a Bilateral Official Development Assistance	
1.b Multilateral Official Development Assistance	
2. Other Official Flows (OFF) = Non-concessionary finance	
2.a Other Official Bilateral Flows	
• OOF except export credits	
• Official direct export credits	
2.b Transactions with Multilateral Agencies at Market Terms	
Private Flows	Not publicly available
3. Private flows at market terms	
3.1 Bilateral Private Flows	
• Guaranteed export credits	
• Non-guaranteed export credits	
3.2 Multilateral private flows	
4. Net Grants by Non-Governmental Organisations (NGOs)	

Source: Reporting Directives for the Creditor Reporting System. Adapted from Figure 2 page 6. Link: <http://www.oecd.org/pdf/M00033000/M00033362.pdf>

Within official flows, ODA or OA (depending on the type of recipient countries) must meet the following criteria:

- They must be provided by official agencies, including state and local governments, or by their executing agencies;
- The primary objective of each transaction must be economic development and the welfare of developing countries; and
- Each transaction must be concessional in nature and carry a grant element of at least 25% (calculated at a discount rate of 10%).

By contrast, Other Official Flows (OOF) are those transactions to countries on the DAC List of Aid Recipients that do not qualify for ODA or OA, either because the transaction is not targeted for development purposes, or because the grant element (if any) is less than 25%. OOF generally includes export credits, official sector equity, and portfolio investment, along with debt reorganisation on behalf of the official sector at non-concessional terms. **Box C3.2** provides additional information on the way in which the OECD assesses whether lending is concessional or not.

Associated Financing for developing countries is a general term that encompasses financing forms such as “mixed credits”, “mixed financing”, “joint financing”, “parallel financing”, or singly integrated transactions. Generally, Associated Financing refers to transactions where the concessional component is linked to the non-concessional component, that some part of the whole financing package is in effect tied or partially untied, and that the availability of the concessional funds are contingent upon accepting the non-concessional component. Finally, Official Development Finance (ODF) is measured in relation to the total receipts of aid recipients, not for individual donor countries. It is defined as the sum of bilateral ODA, concessional and

non-concessional resources from multilateral sources, and bilateral other official flows made for reasons unrelated to trade.

Box C3.2 *Concessionary Lending*

Concessionary Lending is lending with a grant element of at least 25%, and is also known as a “soft” loan. The grant element reflects the financial terms of a transaction: interest rate, maturity (interval to final repayment) and grace period (interval to first repayment of capital). It is a measure of the concessionality (softness) of a loan. It is calculated as the difference between the face value of a loan and the discounted present value of the service payments the borrower will make over the lifetime of the loan, expressed as a percentage of the face value.

The extent of concessionality can be measured either as the benefit to the borrower, or the opportunity cost to the lender. Both benefit and opportunity cost depend on the interest rate and duration of the loan. In a benefit calculation, concessionality would be calculated from the difference between the interest charged and the market rate of interest that the borrower would otherwise have to pay. In an opportunity cost calculation, the concessionality would be calculated from the difference between the interest charged and the return that the lender could have expected from the next most profitable means of investing the capital. DAC statistics generally measure costs to donors, and consideration of opportunity costs played an important part in determining a reference rate of interest for calculating grant elements. For practical purposes this was set as 10%.

Source: OECD/DAC. 2002. “Reporting Directives for the CRS.” DCD/DAC (2002)21.

For the water sector, the CRS database is estimated to cover 85%-90% of DAC countries’ bilateral ODA between 1990-95. From 1996 onwards the data are close to complete. The main data gap relates to technical co-operation activities in the water sector by Japan (about USD 80 million a year).⁽¹⁾

Data is provided to the DAC on a regular basis, following signature of a loan or grant agreement, in a consistent format according to established DAC rules. The CRS database seeks to capture as much information about a project such that it can be comparable to other countries’ data. Low value grants (under US\$ 10,000) may be grouped for individual recipients.

C3.2.3 *Commitments vs. Disbursements*

In general, data on the purpose of aid are collected for commitments rather than disbursements, as disbursements are considerably more difficult to track than commitments. Some data on disbursements is also collected but not on a consistent basis. It was suggested to obtain disbursement data on a sample basis in order to check whether commitments and disbursements were significantly different in the water sector and analyse the potential causes for such differences, which may include institutional failure to get projects implemented or the lack of good projects. This check can only be done on a sample basis, however, and would need to be done (if a substantial issue with disbursement record is identified) for each regional component.

Focusing on commitment data may result in “lumpiness” of information, along with a gap in terms of what donors commit to, and what they actually disburse (if they fail to disburse funds after they have been committed). This

(1) OECD. 2002. “Informal DAC Meeting on Financing Water Infrastructure on 17 December.” OECD, Paris. Page P. 4 footnote #3

may be corrected by using average data over a relatively long period (e.g., 5 years) in order to increase the statistical significance of the analysis.

C3.3 *HOW CAN I CAPTURE ODA AND OA FLOWS TO THE WATER SECTOR?*

It is important to capture the projects that relate to the “water sector” as defined by the EU Water Initiative, i.e., not only water and sanitation services, but also water resource management. The OECD/DAC data therefore needs to be manipulated in order to obtain the right data for the purpose of the EU WI. What follows explains how this can be done.

C3.3.1 *The CRS Sector Breakdown*

As mentioned above, information by sector is contained in the CRS database, which allocates projects to the following categories:

- **Social infrastructure and services**, which includes the sectors of education, health, population, water, government and civil society;
- **Economic infrastructure and services**, which includes transport, communications, energy, banking and finance, and business services;
- **Production**, which includes agriculture, forestry, fishing, industry, mining, construction, trade and tourism;
- **Multi-sector/cross-cutting**, which includes general environmental protection, women in development, and other multi-sectors including urban and rural development;
- **Non-sector allocable**, for contributions such as balance of payments support, actions related to debt, emergency assistance and internal transactions in the donor country.

Each activity is allocated a “sector code”. Note that in DAC reporting (as well as in most donors’ reporting systems), each activity can only be assigned one sector code. For activities cutting across several sectors, either a multi-sector code or the code corresponding to the largest component of the activity is used. This means that water sector activities are captured in a series of specific codes under “Social infrastructure and services”, but broader projects with a water component could also appear in others, such as health, energy (e.g., dam building), environmental protection, urban and rural development or emergency assistance. As a result, water activities included in those broader projects, such as health programmes, are left out. However, the OECD has estimated that the bias introduced by this system is low, which is why this allocation system has been retained.

Also note that for analysing the sectoral targeting of aid (i.e., the percentage of aid flows allocated to a particular sector over total aid), it is preferable to do so on the basis of “allocable aid”, i.e., the aid that is effectively allocated to such or such sector. This would therefore exclude emergency aid, which is in response to unexpected events and is not programmed in advance. Overall, approximately 65-60% of DAC Members’ bilateral ODA is sector allocable. ⁽¹⁾

(1) See OECD. 2002. “Informal DAC Meeting on Financing Water Infrastructure on 17 December.” OECD, Paris. Page 6, footnote 4.

C3.3.2

Defining the Water Sector

The DAC/CRS statistical definition of aid to water supply and sanitation covers the following category (with CRS codes in brackets):

- Water resources policy and administrative management (14010);
- Water resources protection (14015);
- Water supply and sanitation – large systems (14020);
- Water supply and sanitation – small systems (14030);
- River development (14040);
- Waste management and disposal (14050);
- Education and training in water supply and sanitation (14081).

As seen, this definition does not specifically include activities related to integrated water resource management or to the management of water as an ecosystem. On the other hand, some activities are included (such as waste management) which do not clearly belong to the water sector. For the purposes of the EU WI Financial Strategy, this definition was revised on the basis of the following observations:

- Although waste management and disposal mostly include solid waste related activities, it is included for the sanitation element and does not represent a large portion of the total.
- According to DAC classification, dams and reservoirs primarily for irrigation and hydropower, and activities related to river transport are excluded (classified under aid to agriculture, energy and transport, respectively).
- Flood planning and management is classified under “environmental policy and administrative management”.
- There is currently no sub-sector code that would reflect all “Integrated Water Management” activities, and activities related to setting up and supporting river basin authorities would be included in water resources policy (14010).

Therefore, our proposed definition of the water sector was to slightly enlarge the DAC definition, in order to include activities that more closely reflect the objectives of the European Water Initiative, as follows:

- Include waste management-14040 (as it only represents a small share of the total, excluding it would risk excluding important activities, and waste management activities can have a significant impact on pollution prevention and preserving water resources);
- Include agricultural water resources- 31140 (with irrigation, reservoirs, hydraulic structures, ground water exploitation for agricultural use, reflecting the EU WI’s emphasis on food security);
- Include flood/prevention control- 41050 (control of floods from rivers or the sea, including sea water intrusion control and sea level rise related activities) as flood prevention has become a very significant item of water resource management, particularly in the context of global warming.

No other sub-sectors were identified as being clearly related to the water sector and were therefore not included in the definition of the water sector for the purposes of this paper.

C3.4 *HOW CAN I CAPTURE FLOWS ORIGINATING FROM THE EUROPEAN UNION AND FLOWING TO A GIVEN REGIONAL COMPONENT OR COUNTRY?*

C3.4.1 *Identifying flows originating from the European Union*

Flows from the European Union can be captured as follows:

- All flows originating from the EU member states on a bilateral basis;
- All flows from the European Commission and the European Investment Bank. For the former, however, it must be noted that to date, only flows through the European Development Fund are currently reported to the OECD DAC database, i.e., flows to the ACP countries. Therefore, information on flows to other regional components, especially EECCA, would need to be obtained through other sources, and mainly through the European Commission itself; and
- Flows originating from the EU, extending to the water sector by other multi-lateral organisations (eg the World Bank) must be estimated, on the basis of Member States' contribution to those multi-laterals and the sectoral allocation of those multi-laterals' spending. Such estimates must be obtained directly from the OECD, as they are not directly available on the web (see *Annex E* for an application of this analysis to Sub-Saharan Africa).

C3.4.2 *Identifying flows to specific regional components or countries*

On the recipient side, the identification of flows per region is easy using the OECD regional groupings. However, each regional component should check which countries are included in the OECD's regional definitions to ensure that those definitions reflect those of the EU WI.

Note that some activities may benefit several aid recipients and this can make the country-by-country analysis more difficult. Regional projects and programmes are reportable under the most specific available "unallocated" category: e.g., using "South of Sahara unallocated" for projects in West Africa. The category "developing countries, unspecified" is used if an activity benefits several regions. Thus, this is one area where some of the funding to the water sector in a specific country or region may not be captured.

C3.4.3 *Reconciling with aid flows as tracked by recipient countries*

During the working group discussions, the issue of reconciling data originating from the OECD/ DAC database with that compiled by recipient

countries was mentioned as an area that could shed light on the true amounts of aid being disbursed. In practice, and based on limited observations, it appears that the data compiled by the OECD can be different from the data compiled by recipient countries. This may be due to varying reporting structures, and may also be impacted by the lack of equivalent transparency and public administrative capacity in recipient countries' governments. An additional source of difference comes from the fact that most recipient countries would not include in their accounts technical assistance flows (This was the case in Mali, for example, when the OECD conducted an analysis). (see **Box C3.3.** below). As a result, it appears preferable to focus on data provided by the OECD database as it is the most reliable and comparable data assembled.

Mali presents an interesting case study exposing some of the difficulties in tracking and accounting for donor aid. Donor aid is accounted for in different ways depending on the type of flow, and not all of these flows are captured by the Malian government's accounting systems. In Mali, this is a significant issue since donor aid historically accounts for between 15-20% of GDP. Aid from the EU and other donors to Mali is channelled through the following:

- National budgets;
- Project aid that is partially or fully integrated into national budget procedures;
- Project aid that is used to support the government;
- Residual aid (unrecorded public sector aid, or all aid that is not for budgets or government project aid); *and*
- Residual aid (aid to parastatals, to civil society and decentralised bodies, and technical cooperation and operation of agencies).

As part of an OECD/DAC study, the variance between actual flows as tracked by the OECD and accounted-for flows by the Malian government were tracked over a period of time, and this variance was estimated to be about one-third.

Diverse donor and recipient procedures for accepting aid flows provide a great insight into the need for increased cooperation among donors to improve targeting of funds. For instance, the cycle of expenditure in aid actions may be split into three phases: the pledge, payment order, and execution. Within Mali, there are many different types of pledging practices. At the pledge stage, donors may either sign comprehensive annual agreements with the Malian party, or general agreements, or no agreement whatsoever. Pledging in itself may mean different things depending on the donor, and the agreements that are signed by Mali and its external partners are not stored in a complete database. Payment order procedures are even more varied.

The OECD DAC study found that the diversity of stakeholders in Mali had a negative impact on the circulation of information about development, especially as there is no centralised entity keeping track of this information. Second, many aid management bodies lack a financial or accounting capacity, and are therefore divorced from the national budget process. Finally, it is rare for a national body to have responsibility for the entire process of an aid transaction, and so there is no one source for information about the transaction from pledge to execution.

None of these aid flows are fully accounted for by the national government, while the latter may be tracked through regular surveys of donors. Further troubles arise when considering the impact that changing development policies have on accounting instruments. As donors move from project-oriented to a more programme-based approach, accounting for aid within the constrictions of existing fields in accounting systems become more difficult. Even if donor commitments and disbursements could be linked to national budgets, this does not mean that a comparison would yield the same figures. Donors' accounting may be divided into budget aid and operating expenses. While budget aid would likely match, operational expenditures would not, as Mali does not receive those funds as part of an aid package.

All of these point to the need for reform within aid accounting, as well as the need to harmonise definitions and processes amongst donors to improve of coordination and communication.

C3.5

WHAT ADDITIONAL INFORMATION IS AVAILABLE IN THE OECD/DAC DATABASE AND HOW CAN I MAKE USE OF IT FOR SECTORAL ANALYSIS?

The OECD/ DAC database contains other types of information which can be useful to better understand whether current aid flows are adequately targeted or not. These include policy markers and information about the tying status of the project. We provide additional guidance below about how to use this additional information for the purpose of the EU Water Initiative analysis.

C3.5.1 *Policy markers*

The sectoral data are supplemented by information on the policy objectives of aid, such as environmental sustainability, gender equality, reduction of poverty, and participatory development/good governance. For each of the projects contained in the database, these markers can be reported using three types of assessments, i.e. whether:

- The project uses a policy marker as a principal objective;
- The project uses a policy marker as a significant objective; or
- The project is not targeted to any policy objective.

As the marker data are qualitative, each transaction may have more than one marker. However, some DAC members are reluctant to use those markers as they would argue that all their official development assistance has “poverty reduction” as a primary objective, for example.

Of the EU Member States, Denmark, Finland, Germany, the Netherlands, Sweden and the United Kingdom provide marker data for the majority of their reported activities in the water sector. Out of the total number of water projects screened against policy markers in Sub-Saharan Africa, less than half were reported as direct assistance to poor people (as a primary or significant objective); and one-fourth were labelled as targeting gender equality. For comparison, about two thirds of activities in the health sector had been reported as poverty-focused and one-third as targeting gender equality.

Due to the lack of comprehensive information on policy markers and their slightly controversial status, it is not recommended to use them for the purpose of the EU Water Initiative regional analysis.

C3.5.2 *Tracking tied aid*

Information on the “tied” status of aid is available in the OECD/ DAC database and can potentially provide useful information about whether aid is tied, and whether there is a potential for improving the targeting of aid programmes (if a substantial amount of aid is tied, the potential for restructuring and improved targeting may be limited).

This information is available in the OECD/DAC database and can be used, but it is only partial as several donors have had difficulties in reporting the tying status of all individual aid activities. In addition, discussions led to the recommendation that it was not worth focusing too much attention on the tying status of aid, partly because this would be less relevant for future flows than it has been for past flows, following the OECD’s success at putting pressure on its members for untying aid (see *Box C3.4.* below).

In 1987, the DAC established guiding principles for associated financing and tied and partially untied ODA, and has voiced cautions against tying aid, in an attempt to maximise aid effectiveness. According to the DAC, a transaction is tied or partially untied if it meets the following criteria:

- It is the subject of a formal or informal understanding to that effect between the donor and the recipient;
- It involves elements that the DAC and Participants in the Arrangement on Guidelines for Officially Supported Export Credits may determine to result in tying or partially untying.

DAC's guiding principles request that member states make available their criteria for selecting projects and programmes financed by tied aid, to conduct evaluations that include the effects of tying on development effectiveness and aid or trade distortion, and to make this information available to the DAC's regular reviews. These are explained in some detail in "Reporting Directives for the Creditor Reporting System", which can be found online at the following address: <http://www1.oecd.org/dac/htm/CRSdir2002.htm>, page 68.

Most importantly, DAC Members are requested to pursue the greatest possible levels of transparency with tied and partially untied aid, noting however that associated financing transactions whose ODA component consists solely of technical cooperation are exempted, provided that the technical cooperation remains below 3% of the total value of Associated Financing transaction or below US\$1 million, whichever is lower.

Further, the DAC developed a recommendation for members to try to the greatest extent possible to untie ODA to the least developed countries in the following areas by 1 January 2002: balance of payments and structural adjustments support; debt forgiveness; sector and multi-sector programme assistance; investment project aid; import and commodity support; commercial services contract; and ODA to non-governmental organisations for procurement-related activities.

Source: OECD. 2002. "Reporting Directives for the Creditor Reporting System. OECD, Paris.

C3.6

IDENTIFYING GAPS IN AVAILABLE DATA

While the OECD/DAC and CRS databases are the most comprehensive and consistent source for data available to the EU and its Member States for information about aid flows, there are some gaps with regards to how the data can be used for the EU Water Initiative. The following list is not exhaustive; however it could serve as the basis for further discussion within the Initiative, and in particular, with the OECD which is currently looking into improving the user-friendliness and sectoral relevance of its data gathering exercises.

OECD DAC/CRS tracks past, not future, aid flows

While the OECD DAC and CRS databases provide a good picture of past and ongoing efforts in the water sector, the data do not allow for making projections on future funding (no data are collected on planned activities) Within the EU Member States, budgetary planning varies widely, from 5-year projections to a maximum of 1-year projections, making the coordination of information on future flows even more difficult. As a first approximation, it was deemed that facilitating a better understanding of EU Member States aid strategies in the water sector would be required. The Working Group suggested that organising a workshop on such issues with all Member States would be instrumental in obtaining a first basic understanding. This may be

most usefully done at the level of regional components and the regional financial analysis proposed in this document, could provide a good basis for discussion.

Other limitations of the OECD DAC/CRS

Other factors limiting the usefulness of the OECD DAC/CRS databases for the purposes of the EU Water Initiative can be summarised as follows:

- *There are no comprehensive data about aid to IWRM-type activities* – this may reflect a current dearth of international assistance in this arena, but given that IWRM is a major cross-cutting component of the EU WI, developing a “sub-sector” code reflecting those activities may be forthcoming;
- *The DAC/CRS does not capture off-balance sheet commitments that national governments may grant for the water sector, leaving a whole range of funding unaccounted for, such as guarantee schemes* – this could be a major impediment to a more innovative use of guarantees as a way of providing financial support to the water sector, as was recently suggested in the GWP/ WWC Panel on financing water infrastructure's Final Report. Taking guarantees into account in aid statistics may be complex from an accounting and methodological point of view. These issues need to be addressed at a broader level at the DAC Committee rather than just for the water sector.
- *As some donors shift from project-based to programme-based or budgetary support, the DAC water sector categories may lose some of their definitional strength.* Similarly, this issue has not been addressed directly by the DAC committee but is likely to become increasingly critical.

C4 TRACKING PRIVATE SECTOR FLOWS

C4.1 RATIONALE

This information sheet identifies what is captured by the PPI database maintained by the World Bank, a key source of information for tracking flows originating from the private sector.

There is no uniform source for information about private sector participation in the water sector. Instead, there are many sources, including the private companies themselves (for marketing purposes); flows tracked by the OECD (although these are not available publicly), and the World Bank's Private Participation in Infrastructure (PPI) Database. Individual Regional Components may find other sources of information on private flows to be more relevant, especially in specific publications.

C4.2 THE PPI DATABASE

The PPI database maintained by the World Bank includes information on infrastructure projects that include private sector investment. The PPI database is the most comprehensive single source of data on private sector flows available, and it is continually looking for ways to improve, and to match with other development processes. Up to now, individual queries must be submitted to the PPI database manager directly. As of May 2003, the PPI Database has become available online to the public.

Data is included for projects that have reached financial closure, and which directly or indirectly serve the public and are sponsored in part by the private sector, and which are developed in low and middle-income countries, as defined and classified by the World Bank. A foreign state-owned company is considered a private entity, irrespective of its actual ownership structure.

The PPI Database's definition of the water sector includes the following activities for potable water and sewerage: generation and distribution (water supply); collection and treatment (sewerage).

Limitations of the PPI database

- The PPI Database does *not* include private sector participation for supply and civil work contracts; technical assistance contracts; subcontracting or contracting out of services; turnkey contracts; or fully commercial financing, i.e. from commercial banks.
- The PPI records initial investments rather than ongoing operational expenses.
- The PPI database addresses deals that have reached "financial closure" – but does not include the "structured finance" market.

C5.1 RATIONALE

This information sheet (a) analyses the indicators that have been identified to assess the impact of financial flows on meeting the EU WI objectives and (b) formulates recommendations for developing others

Indicators serve to assess whether financial resources are being effectively spent and adequately targeted. What really matters is not the total amount being spent, but the effective impact that those flows have towards meeting the EU WI's targets and Millennium Development Goals. This analysis is presented in detail in *Annex B* containing the Guidelines for analysis.

Unfortunately, very few reliable indicators are currently available, apart from indicators of access to water and sanitation services. Based on this observation, the EU Water Initiative has recently contributed to the establishment of a component on monitoring and evaluation that will in time produce adequate indicators for monitoring progress and is working with other international efforts, such as the Millennium Task Force, to try and improve this data (see *Box C5.1* below). The OECD is currently developing indicators for tracking funding flows in the water sector. Further, in collaboration with the United Nations Millennium Development Project, the OECD has selected the water sector as a priority for improving data collection and analysis among all of the other sectors represented by the MDGs.

Box C5.1 *Monitoring and Evaluation Access Indicators*

The Millennium Task Force, as part of the Millennium Development Project face a dual challenge: to see how far it can go with existing data, or to improve the current situation through an alternative mechanism, such as creating an international database that is consistent with the MDGs, as presently defined. The position of the Task Force is to recognize that there are problems with both the definitions and the achievement of the MDGs. There is thus a need to move forward on achievement, while at the same time improving upon the definitions and data. The EU Water Initiative, as a supporter of the MDGs and the Millennium Development Project, will maintain its relationship with the Task Force as they further define and develop monitoring and evaluation mechanisms to track progress towards the MDGs, and will adopt mechanisms that are in line with the EU Water Initiative's goals.

Source: and Adapted from Task Force on Water and Sanitation, United Nations Millennium Project. 2003. "Achieving the Millennium Development Goals in Water and Sanitation, Background Issues Paper." p. 22.

C5.2 ACCESS TO WATER SUPPLY AND SANITATION

The most basic indicator for water and sanitation services is the percentage of the population having access to such services. To obtain this information, the World Health Organisation/UNICEF Joint Monitoring Programme (JMP)'s "Global Assessment 2000" was used, as it provides the most comprehensive

set of data for both 1990 and 2000. ⁽¹⁾ This database, however, suffers from a number of shortcomings, and in particular, can yield over-estimates of access data, as discussed below:

- The JMP was dependent on data reported by countries themselves and is therefore exposed to potential bias due to self-reporting;
- There is no consistent definition for “safe or improved water supply and sanitation facilities” across countries or within the same country over time;
- Coverage data for 1990 was based on estimates by service providers, rather than on responses of consumers to household surveys, which can skew the estimates;
- Although coverage data for 2000 was based on estimates by service providers and household surveys, there is a lack of standard indicators and methodologies for household surveys in different countries and regions, adding a level of complexity to the interpretation of “access.”

The JMP is aware of these shortcomings and working on addressing them. Despite these shortcomings, it is recommended to use this database in the short-term as it provides the best basis for comparing access across countries and sectors (water and sanitation, rural vs. urban).

C5.3 *INTEGRATED WATER RESOURCES MANAGEMENT (IWRM)*

Integrated Water Resources Management is acknowledged as a critical part of water sector management, but indicators to guide its development are weak or non-existent.

Given that the EU Water Initiative has set a target for all countries to develop water efficiency plans by 2005, the establishment of such plans could provide an initial indicator of success. However, there are several issues in doing so:

- First of all, it is unclear whether this deadline can technically be met, given the complexity of such a process, and the exact content of what is meant by a “water efficiency plan” is still to be determined;
- The 2005 deadline introduces the risk that countries will draft plans without considerable attention to participatory planning and sufficient process to address environmental and social risks and will fail to integrate such planning process with parallel initiatives for poverty reduction.

C5.4 *IDENTIFYING GAPS IN AVAILABLE DATA*

A considerable amount of work remains to be done on improving the availability and quality of indicators to monitor progress towards targets. To improve the precision of monitoring, there is the potential for going into quite a high degree of detail and complexity, although this would only be needed at a later stage. At this early stage, it was deemed preferable to focus on simple indicators as they may be more reliable.

(1) See WHO/UNICEF. 2000. Global Water Assessment 2000: Annex A, Methodology for the Global Water Supply and Sanitation Assessment 2000, http://www.who.int/water_sanitation_health/Globassessment/Global1.htm

Improvements required would be as follows:

- ***Improve the quality of indicators of access to water and sanitation services by establishing a common methodology for defining access*** (e.g., whether it is having access to those services in the house or access to a standpipe within a given distance of the house. Given the diversity of access conditions throughout the world, the definition of “basic access” may need to be varied along regional lines;
- ***Accompany the development of indicators for IWRM:*** going beyond whether or not countries have adopted a water efficiency plan, it would be important to develop indicators of the sustainability in the management of water resources;
- ***Consider the possibility of developing aggregated indices:*** there have been attempts at constructing a “Water Poverty Index”, which would provide a comprehensive picture of the sustainability of water uses. However, these types of composite indicators are complicated to put together and it was too early to rely on these for this analysis;
- ***Try to match information on data flows with specific monitoring indicators:*** given that information on ODA flows can be tracked by sub-sectors (e.g. water supply and sanitation, river development, flood prevention and control, etc...), a more refined analysis would seek to track flows by sub-sectors and match them against their relevant indicator. This could only be performed at a country level, and would require the development of appropriate IWRM indicators.
- ***Indicators of “spending performance” could also be developed, although the level of complexity (in obtaining data and computing the indicator) could again be quite high.*** For example, it was suggested that it would be useful to obtain data on the number of people benefiting (e.g. number of new people connected to the network) per dollar spent. However, this requires a lot of data that is not currently collected by the OECD or other bodies and could not be computed at this stage.

The following glossary presents terms from the OECD's DAC Statistical Reporting Directives, which can be found at the following web-page: <http://www1.oecd.org/dac/htm/dacdir.htm>.

Associated Financing in developing countries associates in law or in fact two or more of the following: Official Development Assistance (ODA), Other Official Flows (OOF) with a grant element of at least 25%; or officially supported export credits, other official flows or other funds with a grant element of less than 25%. Associated financing transactions may take forms such as "mixed credit", "mixed financing", "joint financing", "parallel financing" or single integrated transactions. Their main characteristic is that the concessional component is linked in law or in fact to the non-concessional component, that either the non-concessional or the concessional component or the whole financing package is in effect tied or partially untied, and that the availability of concessional funds is conditional upon accepting the linked non-concessional component.

Official development assistance (ODA) is defined as those flows to typically developing countries, which are included in the DAC List of Aid Recipients, and also to multilateral institutions for flows targeted to these countries. These flows must be provided by official agencies, including state and local governments, or by their executing agencies. Each transaction must promote economic development, with the welfare of developing countries as the primary objective; and, each transaction must be concessional and convey a grant element of at least 25% (calculated at a discount rate of 10%).

Official aid (OA) consists of flows that meet all of the same parameters of ODA, except that they are directed to transitional countries as listed on the DAC List of Aid Recipients, and to multilateral institutions that benefit, primarily, transitional countries.

Other official flows (OOF) are those transactions by the official sector to countries on the DAC List of Aid Recipients that do not meet the conditions for eligibility as ODA or OA, either because the transaction is not primarily aimed at development, or because the transaction does not include a grant element of at least 25%. OOF generally includes official export credits, official sector equity and portfolio investment, and debt reorganisation undertaken by the official sector at non-concessional terms (irrespective of the nature or the identity of the original creditor).

Official development finance (ODF) is measured only in relation to the total receipts of aid recipients, not for individual donor countries. It is defined as the sum of bilateral ODA, concessional and non-concessional resources from multilateral sources, and bilateral other official flows (OOF) made available for reasons unrelated to trade.

Bilateral transactions are those undertaken by a donor country directly with an aid recipient. They also include transactions with national or international non-governmental organisations active in development and other internal development-related transactions such as interest subsidies, spending on promotion of development awareness, debt reorganisation, and administrative costs.

Multilateral transactions are those made to a recipient institution which:

- conducts all or part of its activities in favour of development
- is an international agency, institution or organisation whose members are governments, or a fund managed autonomously by such an agency; and
- pools contributions so that they lose their identity and become an integral part of its financial assets.

A **commitment** is a firm written obligation by a government or official agency, backed by the appropriation or availability of the necessary funds, to provide resources of a specified amount under specified financial terms and conditions and for specified purposes for the benefit of the recipient country.

A **disbursement** is the placement of resources at the disposal of a recipient country or agency, or in the case of internal development-related expenditures, the outlay of funds by the official sector.

Tied aid credits (tied and partially untied loans and grants and associated financing) are subjected to disciplines concerning their concessionality levels, recipient countries and developmental relevance. These disciplines are designed to ensure that aid is not used for commercially viable projects and that recipient countries receive good value for money.

Untied aid is defined as loans and grants whose proceeds are fully and freely available to finance procurement from all OECD countries and substantially all aid recipient countries.

Partially untied aid is defined as loans and grants which are tied to procurement of goods and services from the donor country and from a restricted number of countries which must include substantially all aid recipient countries.

Grants are transfers in cash or in kind for which no legal debt is incurred by the recipient. For DAC/CRS reporting purposes, it also includes debt forgiveness, which does not entail new transfers; support to non-governmental organisations; and certain costs incurred in the implementation of aid programmes.

Grant-like flows comprise a) loans for which the service payments are to be made into an account in the borrowing country and used in the borrowing country for its own benefit, and b) provision of commodities for sale in the recipient's currency, the proceeds of which are used in the recipient country

for its own benefit. Note that transactions in which service payments are to be applied to the benefit of the donor country, even if they are to be held in the recipient country while awaiting use, are recorded as loans, and are classified as ODA/OA or OOF, as appropriate.

Loans are transfers for which the recipient incurs a legal debt and repayment is required in convertible currencies or in kind. This includes any loans repayable in the borrower's currency where the lender intends to repatriate the repayments or to use them in the borrowing country for the lender's benefit.

Equity investment comprises direct financing of enterprises in the aid recipient country which does not (as opposed to direct investment) imply a lasting interest in the enterprise.

Annex D

Sources of finance, the
policy environment and
potential building blocks
for the EUWI

This Annex presents details on the sources of finance that are potentially available to the water sector, under the aegis of the EUWI; the policy environment within which water financing works and some potential policy or financing building blocks that the EUWI could position itself upon.

The Annex is outlined as follows:

- *Information Sheet D1* discusses the different ways of accessing more finance for the water sector;
- *Information Sheet D2* discusses different institutional providers of finance, including the EU donor community;
- *Information Sheet D3* discusses the wider policy building blocks the EUWI could position itself upon

Each section is presented in the form of an “Information Sheet” in order to cross reference with *Annex B*, an overall Guidance Note that describes in practical terms our approach to this analysis.

This information sheet provides an outline of the different ways in which more finance could be drawn to the water sector

D2.1

INTRODUCTION

Finance for the water sector can come from different sources. This section looks at ways of obtaining finance from:

- Users (via tariffs and subsidies)
- Environmental charges
- Grants
- Loans
- Mixed Credits and Export Funds
- Micro-Finance
- Output Based Aid
- Bond Markets
- Equity Stakes
- Direct Private Investment
- PPP/ PFI Initiatives
- Voluntary Finance Schemes
- Sector Wide Approaches and Funds

Importantly, these are simply instruments for obtaining finance and the following information only describes what these instruments are. The *institutional* contexts within which they are used (whether the finance instrument is used or promoted by the users themselves, the state water agency, state or national governments, international aid agencies or the private sector, for example), and the comparative advantages, problems and constraints these institutional contexts may possess, are considered later.

At the end of each description a text box prompts the question of how a better use of aid may help develop the particular instrument for obtaining more finance in the water sector.

D2.1.1

This information sheet can be used in conjunction with Step 2.B of the Guidance Note (Annex B), providing a route to help analyse the kinds of finance instruments that may be available.

D2.1.2

Sources of Finance

Finance from users via tariffs and subsidies

User revenues derived from tariffs are the primary source of finance for water and sanitation services. Water and sanitation services that raise revenue from users to cover operation and maintenance costs are likely to be financially autonomous in the short run. Further, water and sanitation services that can derive a suitable rate of return or surplus from their assets are likely to be financially sustainable in the longer term. This flow of revenue can then be a useful guarantee against which further finance for investment or expansion can be obtained.

A tariff is the best vehicle by which revenues from water users can be captured. The goal of any tariff is to capture as much of a person or household's willingness to pay for the service as possible without being too high to drive consumers to unsafe alternatives.⁽¹⁾

Tariffs are generally calculated with guidance from a national or state policy, although the public or private sector can also calculate them for an individual programme. Whether designed by the public or private sector, tariffs can be designed within a pro-poor policy framework. Importantly, tariffs for water and sanitation are generally composed of two parts: firstly a charge focused on covering the ongoing costs of supply (perhaps measured on a volumetric basis) and secondly a lump sum or fixed fee connection charge and/or an infrastructure upkeep related fee (related to the network that serves the customer, or the cost of connecting the customer to that network).

Tariffs are often set well below a level where the service provider can feasibly recover even operations and maintenance costs, and publicly-run water utilities are often under political pressure to keep them down. Therefore *tariff reform*, in the form of aligning tariffs with the actual costs of providing the service, is often seen as a critical element for increasing finance to the water sector.

Some of the benefits of tariff reform include:

- Funding comes from water users themselves, reducing dependence on public funds, private finance or aid flows;
- Any increase in water demand could generate associated revenues to finance expansion (although this depends on the level of tariffs when compared to long-run marginal costs);
- Cost-recovery tariffs make the service attractive for private sector participation and can therefore help to attract additional forms of private finance, if needed.

However, it is of critical importance to realise that it is the amount of revenue that is actually collected from customers (and not the tariff per se) that provides the cash life-blood to water service providers. Hence, institutional and affordability issues are as critical to the financial success of the reform process as the tariff design itself.

Ways of using subsidies to help alleviate the affordability problems of higher tariffs are described in *Section D.2.1.4*. Firstly, some descriptions of common types of tariffs and subsidies within the water and sanitation services sector that could be implemented if a reform process were to occur are presented.

⁽¹⁾ It is useful to distinguish between **charges and tariffs**. A charge is amount set for a given quantity (of water and sanitation service in this case); for example, the charge could be US\$3 per m³ of water. A tariff, however, is a schedule of prices for (for water and sanitation services) set by an institution (the government). So the overall tariff may be an increasing block tariff, but the charge for water per m³ within each of these blocks may be different.

As discussed above, tariffs are by far the largest source of revenue for water services worldwide, although the levels to which tariff recovery is successful depends on the region. Further, the success of a tariff is invariably linked to the ability of the service provider to link water usage with charges through metering. In this section we discuss the following types of tariffs:

- Single Tariff
- Increasing Block Tariff
- Lifeline Tariff (also known as a Social Block Tariff)
- Output-Based Tariff

Some commentators also advocate the use of a so-called two-part tariff.

Single Tariff

Single tariffs are also called a uniform volumetric charge. Under this structure, consumers are charged a standard rate per m³ (or other volumetric measure) regardless of their incomes or level of use. Sometimes single tariffs are differentiated by type of user, such as residential, commercial, or agricultural. The benefits of the single tariff are in its simplicity with relatively low administrative costs; however, there are no incentives for conservation, and the tariff rates may not be high enough to recover the costs of supply.

Increasing Block Tariffs

Increasing block tariffs are by far the most common tariffs for water services. Under a block tariff scheme, users are charged increasing amounts based on the amount of water used.

While the number of blocks can vary, most block tariffs range from between 3 and 10 blocks, provided that the first block allows for a basic standard of water at an affordable rate. Generally, prices increase sharply at higher levels of consumption in order to pay for this first block. In theory, block tariffs allow the poor to benefit from water services at low prices. In practice, if many poor consumers share a single water connection under a block tariff, this drives consumption – and prices – much higher than if they each had a private connection (which is generally not affordable). Further, most block tariffs often provide such a large initial block that neither the poor nor the non-poor need to access into higher levels of consumption, thus reducing the effectiveness of the cross-subsidy. With this situation, effective cost-recovery is not possible.⁽¹⁾

Lifeline Tariffs (also known as social block tariffs)

⁽¹⁾ Boland, John and Dale Whittington. 2000. "The Political Economy of Water Tariff Design in Developing Countries." In *The Political Economy of Water Pricing Reforms*. Oxford University. http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2000/08/14/000094946_00072705342983/Rendered/PDF/multi_page.pdf

A lifeline tariff is similar to an increasing block tariff, but instead is more explicit about being pro-poor by providing a minimal amount of water (for example, using the WHO guidelines of 20 litres per capita per day for basic needs) either for free or at very low cost, with a form of block tariff for consumption above the lifeline level. In theory, the lifeline tariff provides an equitable solution to address the needs of the poor. However, lifeline tariffs also break the link of accountability between the water user as a consumer, and the service provider. As such, while those poor who are connected to a network may not be assured a high quality of service for their 20 litres per day, the poorest of the poor – those who are not able to afford connections to the network – do not benefit at all.

Output-based Tariffs

With an output-based tariff, users are charged a distinct tariff based on an agreement with the service provider for a schedule of improvements to service levels. This system is fairly straightforward and transparent as it is based on a contract between the service provider and the consumers, who can see the benefits of the tariffs they pay over time. While output-based tariffs represent an innovative and perhaps the most progressive approach to tariff design, they are not yet widely used.

Two Part Tariffs

A two-part tariff consists of a monthly charge paid by all customers, plus either a single volumetric charge for consumption above a certain volumetric level (the marginal cost of supply), or a fixed monthly credit for those users whose consumption is below that level. The purpose of a two-part tariff is to build a culture of payment for water services, while not penalising low water consumers with high bills.

D2.1.4

Subsidies

It is generally agreed that while tariffs should cover the costs of supplying water, subsidies are necessary to ensure that the poor are able to afford connection charges or to help pay their bills. The need for subsidies to help provide WATSAN services to the poor is understood and widely accepted.

Different types of subsidies can achieve different purposes. Some types of subsidies are better than others, depending on the type of project, and the level of public capacity to manage and administer them. In this way, subsidies and tariffs are highly interrelated.

(1) Information and analysis about South Africa's Free Water Policy can be found at: <http://www.thewaterpage.com/Principles.htm>.

(2) Boland, John and Dale Whittington. 2000. "The Political Economy of Water Tariff Design in Developing Countries." In *The Political Economy of Water Pricing Reforms*. Oxford University. http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2000/08/14/000094946_00072705342983/Rendered/PDF/multi_page.pdf

Direct subsidies

Direct subsidies aim to target the poor through government payment of a portion of poor consumers' water bills. Direct subsidies are used in Chile and Colombia⁽¹⁾, and have been effective to varying degrees. One drawback to direct subsidies is their high administrative costs, which may be prohibitive for governments experiencing budget constraints, or lacking public administrative capacity. In Chile, for example, subsidy recipients are determined through a national socio-economic survey that provides information on households to multiple government agencies offering subsidies for many different public services.

Cross subsidies

By type of use or volume - One common way to cross-subsidise is to introduce differentiated tariffs according to the type of use (typically, industrial users cross-subsidise household users) or the quantity consumed (with "dissuasive" tariffs for higher levels of consumption). Based on extensive research and case analysis, it has been established that: (i) such increasing-block tariffs reduce the availability of funds for long-term investments in network extension, and (ii) they can be regressive, as they may drive prices up for large families or those using a shared connection, such as the poor. Errors of inclusion (whereby wealthy families obtain the subsidy) and of exclusion (whereby poor families do not get it) are common and blur the pro-poor characteristics of the subsidy's intentions.

By region - Another common method of cross subsidy is regional, whereby customers with connections all pay the same price throughout the country, irrespective of the supply costs incurred by the water service provider (e.g., servicing peri-urban areas may be more expensive than supplying a city centre). Under this type of cross subsidy, a portion of existing customers' bills would go towards expansion costs for a utility if the customer base is large enough to absorb the extra connection costs. In this way, existing customers subsidize new customers. Such mechanisms have proved relatively effective for extending services beyond the capital city into secondary towns and rural areas. However, they have not proven sufficient to finance universal access across a country's territories.

This latter use of cross-subsidisation is more sustainable from a cost recovery perspective than volumetric or usage cross-subsidies, as the higher cost incurred at higher usage often drive the wealthy users to alternative sources of supply. As such, the poor are ineffectively targeted because the structure of the system is unsustainable in the long term, and in the absence of external assistance.⁽²⁾

Cross subsidies can work to meet the needs of the poor, however they also pose some challenges. They require a considerable amount of monitoring

(1) Foster, Vivien, Andres Gomez-Lobo, and Jonathan Halpern. 2000. "Designing Direct Subsidies for the Poor: A Water and Sanitation Case Study." Public Policy for the Private Sector, Note No. 211. World Bank, Washington, D.C. <http://www.worldbank.org/html/fpd>

(2) Yepes, Guillermo. 1999. "Do Cross-Subsidies Help the Poor to Benefit from Water and Wastewater Services? Lessons from Guayaquil." Water and Sanitation Program, Washington D.C. http://www.wsp.org/pdfs/working_subsidy.pdf

and regulation to ensure a level of cost-recovery for service providers. Depending on the circumstances, they may not be the optimal solution to provide water and sanitation services to the poor. Finally, in very poor countries, they may not be effective, because there is little or no ability to effect cross-subsidy from more advantaged sectors of society where they are themselves at or close to the limit of their own ability to meet the tariffs.

Output-based subsidies

Similar to output-based tariff structures, an output-based subsidy links a level of subsidy with performance levels, generally with regards to extending connections. Here, government tends to provide operators with subsidies to address gaps in cost recovery based on the service delivery levels and other factors that are specified as benchmarks to pro-poor development. Some applications of output-based subsidies include subsidies for expanding coverage (where increasing connections in poor areas are emphasised); to support a transition from an existing tariff structure to a more cost-recovering tariff level (with benchmarks including increased collection rate)⁽¹⁾; and subsidising wastewater treatment by awarding a company for the level of pollution removed (or prevented). In countries or regions where connection is not an issue, output-based subsidies may also be used for consumption.⁽²⁾

Significant research on subsidies and their effectiveness has been conducted over the last several years, with the conclusion that subsidies should be provided only as part of a pro-poor framework, and should be used, generally, to promote access to basic water and sanitation services rather than to provide ongoing support for consumption. Reasons cited include the high administrative costs of providing effective subsidies, and meeting the needs of the poor who are not connected to a network.

Tariff and subsidy choices for different water and sanitation programmes

Clearly, the most effective mix of tariff and subsidy choices to maximise the chances of capturing costs will differ between and within programmes. Different sorts of technology (wells, boreholes, gravity fed systems, private taps, sewerage systems, septic tanks) will require different packages (or ladders) of connection charges and recurrent payments. The issue of whether the scheme can be metered or not will arise, and this will affect the design of tariffs and subsidies. Schemes in urban areas may have slightly more cash-rich users than those in rural areas, or at least users who have some cash throughout the year.

This Annex is not intended to focus on the issue of pricing structure for water or on an analysis of the best mix of tariffs and subsidies. However, an optimal financial pricing strategy will aim for coverage of long run marginal

(1) Brook, Penelope J. and Alain Locussol. 2002. "Easing tariff increases: Financing the transition to cost-covering water tariffs in Guinea." In, *Contracting for public services: Output-based aid and its applications*, Penelope J. Brook and Suzanne M. Smith, Editors. World Bank, Washington, D.C. <http://rru.worldbank.org/Documents/08ch3.pdf>

(2) Gomez-Lobo, Andres. 2002. "Making Water Affordable: Output-based consumption subsidies in Chile." In, *Contracting for public services: Output-based aid and its applications*, Penelope J. Brook and Suzanne M. Smith, Editors. World Bank, Washington, D.C.

costs, probably calculated via an Average Incremental Cost approach. For the best mix of tariffs and subsidies, in general, the following guidance seems to hold:

- A volumetric approach, however simple, is the best way forward to form the basis of a tariff.
- An increasing block, lifeline or two-part tariff has the greatest poverty focus. The aim, however, is to keep the tariff simple, easy to calculate and easily understood.
- An output-based element to the tariff could be useful to get first time payees on board, by matching proven performance from the water and sanitation programme to a stated commitment from users to pay once those improvements come on stream.
- The use of credit to smooth lumpy connection payments or to provide assistance to the poorest to ease access to improved water and sanitation opportunities can be extremely useful. Credit, rather than subsidies, can help lock people into a repayment process. Cross-subsidisation from rich to poor within a water and sanitation programme can be complex to monitor and regulate, and ongoing direct subsidies to help with payments can be difficult to target. Neither type of subsidy actively helps to reduce poverty. Instead, subsidies to help provide access may be more useful from a poverty reduction perspective.

D2.1.5 Environmental charges

Whilst covering the financial costs of the service is the primary focus of most water and sanitation finance managers, thinking about the *economic* value of water, which a network is abstracting/ using/ discharging is also important. The economic value of water is important to the EU Water Initiative, as water resource policies within a river basin management component are an underpinning component. Within a context of increasing water scarcity and competition for secure water supplies, the issue of economic pricing and efficient allocation will only increase over the coming years.

Environmental or scarcity cost components could be added to water tariffs, to reflect the economic cost of using water; however this would not likely be a practical way to raise more finance from domestic water users, as bills would become prohibitively expensive. Another approach that could be used to support IWRM activities would be to collect abstraction and discharge (or pollution) charges for all commercial or large scales users in a given river basin. Depending on the sophistication of the river basin authority, regulatory fines could govern the collection and management of these charges, or market-based mechanisms could be used, with a surcharge returned to the river basin authority.

A by-product of implementing environmental charges includes greater coordination among stakeholders in a river basin, cash flow to support river basin activities, and environmental benefits from reduced pollution. This could also have the benefit of raising awareness of water's economic value throughout a river basin area.

Drawbacks include high administrative costs and efforts, the need to regulate, and difficulty in determining baseline price and quantity for abstractions and discharges. Implementing environment charges to raise finance involves addressing a whole range of institutional challenges.

D2.1.6 Grants

Most aid flows are in the form of grants from donors, which are either tied (conditioned upon purchases from suppliers in the donor country) or untied, depending on the type of grant and the policy of the donor. While there are many different types of grants that can be used for different purposes (e.g., seed grants or matching grants), the basic principle behind a grant program is that it does not have to be repaid. In recent years, there has been a clear move away from direct project-based grants by some the EU bilateral donors (most noticeably DFID) towards budgetary support. This trend is premised on the notion that the broader goal of poverty reduction can best be met by strengthening public sector institutions, and enabling them to address development issues themselves. The expectation is that direct budget support – often tied to performance measures – will lead towards better public and fiscal administration and management and will trickle down and address broader development concerns over time.

All donors, however, are aiming to harmonise their ODA to fit better within the context of Poverty Reduction Strategy Papers prepared by (HIPC) recipient countries.

If the water sector, therefore, is not clearly a key component within the PRSP, or does not have a coherent sector strategy action plan, then it will attract less grant-based budgetary support, and will perhaps rely more on “piecemeal” donor projects.

However, when grants are tied to specific projects and programmes, they are too often provided without any performance requirements. This has perhaps contributed to the lack of financial sustainability and overall poor performance within the water sector and the belief that water lacks an economic value.

Another key issue related to gaining more finance for water from overseas aid grants, is that donors increasingly wish to respond to “demand driven” initiatives. This requires the recipient country to prepare good quality project proposals, which clearly fit within the donor's priorities (pro-poor growth, sustainability, co-financing from the private sector or other donors, etc.). A common complaint from EU donors is the lack of good quality project proposals for them to fund. Hence the interest among EU donors in using

overseas aid grants to prepare better projects or to develop project preparation facilities, and to improve national capacities to develop and administer better water sector projects.

D2.1.7 *Loans*

Loans can be provided either on a commercial basis by commercial banks or on a “soft loan” or “concessionary” basis by some bilateral agencies, development banks and international financial institutions.

Commercial loans are often a prohibitively expensive way to raise finance for the water sector. This is because of the range of risks that are perceived to exist by commercial investors in providing private finance and in gaining an adequate return on their investment, for the water sector (see *Section C3*). Hence, the provision of risk guarantees for commercial loans is generating interest as a potentially useful way to use EU aid flows to encourage more commercial loans into the sector.

Soft loans are more commonly used for infrastructure development projects, such as water. They offer low or no interest rates over varying amounts of time, and most of the loan itself – up to 80% – is provided as a grant from the donor country. Soft loans are usually untied, which increases the ability to strengthen local regional economies. Recently, soft loan credits have been used to finance water supply projects in Jamaica and Jordan. In Jordan, a soft loan from Germany was provided to support several governmental and non-governmental organisations to promote sound water management.

Soft loan facilities and mechanisms can help to further infrastructure development by providing finance and programs for projects that would be unable to obtain credit elsewhere. This is possible because the financial institutions offering soft loans (such as the European Investment Bank, or other bilateral finance institutions) are provided with direct subsidies and/or a secure capital rating enabling them to access external finance from the market cheaply. This puts them in a better position to offer soft loans than purely commercial investors.

A specific form of soft loan is the *Poverty Reduction Strategy Credit (PRSC)*. Countries that are eligible for World Bank IDA loans can apply for PRSCs, which were created as part of the shift in strategy towards reform. PRSCs are part of the broader program to support medium-term policy and institutional reform programs to help implement the PRSP process. PRSCs are targeted for specific, prioritised policy actions that have been identified through the PRSP process, and continued funding is contingent upon meeting clearly defined targets.

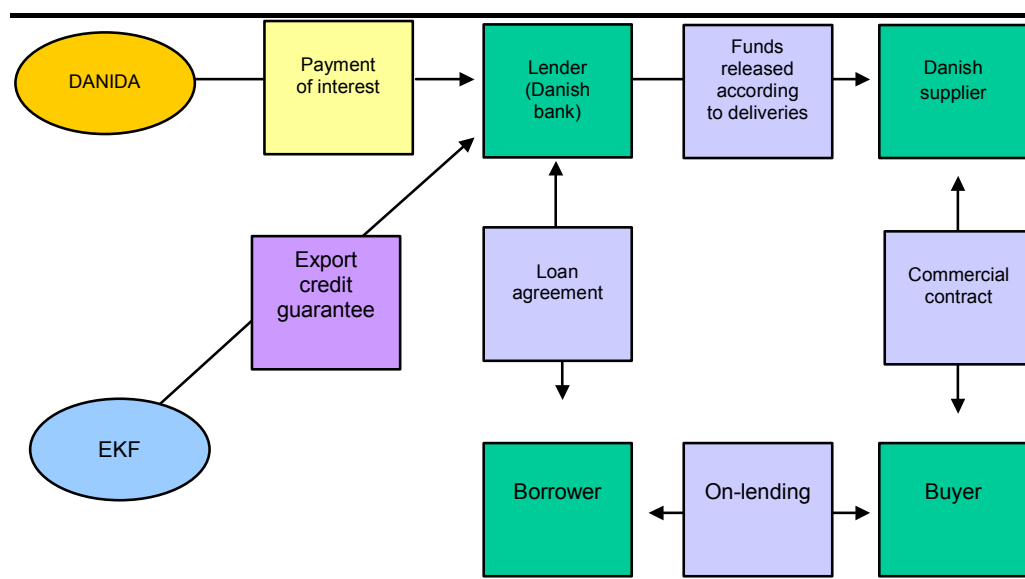
Clearly, therefore, if water is identified within the PRSP then the opportunity to obtain soft loan finance under a PRSC becomes clearer.

Mixed credits combine overseas aid and supplier financing for a project, and generally apply to “hard” infrastructure projects, such as dams, power stations and roads, etc. Because of the stipulations for private financing, many developing countries are unable to access mixed credits. Mixed credits are also often tied, meaning that goods and services must be procured in the country where the funds originate.

Within the OECD, the OECD Consensus Agreement on Export Credits governs mixed credits. This agreement asserts that tied aid credits should “provide needed external resources to countries, sectors, or projects with little or no access to market financing.” Water supply and general environmental matters fit well within this mechanism.

In Denmark, mixed credits are used for infrastructure projects including water supply projects. They are partially tied, interest free or low-interest loans with a maturity of 8-15 years, with a goal to finance development projects executed by Danish exporters in credit-worthy developing countries. *Figure C2.1* shows the different actors and components of the Danish mixed-credit scheme:

Figure D1.1 Danida's Mixed Credit Programme



Source: DANIDA website: <http://www.um.dk/danida/blandedekreditter/Guidelines.pdf>

An advantage to the mixed credit mechanism is the engagement of a financial business model that includes the private sector for infrastructure at affordable terms, along with an emphasis on cost recovery in project design.

Some challenges in implementing mixed credit schemes may include the relationship of the project’s development to demand from developing countries, the integration of a project within the broader water sector framework and ensuring a project’s longer-term sustainability.

D2.1.9 *Export Funds*

Here, a contribution from public funds is used to stimulate private sector participation in developing countries. Most developed countries have export funds, which serve the dual purpose of providing business to companies that are based in the donor country, while providing products and financing for development. In the Netherlands, for example, a maximum of 35% of total costs is used to support Dutch companies' involvement in developing countries, and is used often to enhance involvement in the water sector.

D2.1.10 *Micro-credit/Micro-finance*

Micro-credit mechanisms can raise finance in the water sector by providing start-up capital for local entrepreneurs at affordable rates while promoting self-finance for projects and initiatives. Micro-finance tends to be based on local demand, where the borrower understands basic accounting and finance. In the past, micro-credit mechanisms have not been widely promoted for the water sector, although this has been changing slowly in different places around the world, including Honduras, Indonesia, Ghana, South Africa, India, and Pakistan.

Recent research concerning the application of micro-financing schemes for water and sanitation has shown that it is most effective when individuals and communities are provided with a range of technological and financing options from which to choose. This also corresponds with demand-responsive development approaches. Additionally, cost-recovery and the development of local capital markets are integral parts of micro-finance, which has a strong link to the evolving approach to a more sustainable water sector.

Despite these advantages, emerging research on the potential for expanding micro-credit/finance capabilities have revealed difficulties, due to constraints including perceptions towards savings and credit among the poor, and an overall lack of local institutional and accountancy capability.

D2.1.11 *Output-Based Aid (OBA)*

Under OBA schemes, overseas aid to private firms, NGOs, or the public sector is linked to clearly defined performance indicators. Thus, as development practices shift towards more demand-responsive development approaches, output-based aid provides a practical way to monitor and evaluate the progress and effectiveness of aid funding over time.

An output-based strategy for water can be applied to subsidies and tariffs, contracts, and programs, for example through the PRSP process. As part of the process, donors and recipients need to establish the role of funding, clarify the responsibilities of all parties, define performance, determine how the scheme will be administered, and link payment to performance.

The more widespread use of OBA principles linked to grant funds may raise the profile of cost recovery and other targets for sustainability in the water sector, along with promoting accountability in both systems and financial management.

Currently, the World Bank and DFID are interested in developing OBA approaches.

D2.1.12 Bond Markets

Bond markets can be local (national) or international.

National bonds are debt issued by governments or companies to investors. The main difference between a bond and a regular loan is that bonds are normally tradable to a third party and therefore provide the investors with a possibility to withdraw from the investment without the issuer having to repay the funds. In order for this to work there is a need for a functioning market for the bonds. In developed countries, an active bond market allows for stable and often tax-free investing for infrastructure projects.

Bonds are relatively safe investments, provided that the issuer is stable. The more stable the investment, the lower the interest paid on the investment. In developing countries, bond market development relies heavily on macro-economic conditions and local capacity (e.g., stable inflation, regulatory structures, etc.).

In industrialised countries, water sector infrastructure projects are often financed through bond markets, due to their long-term, stable nature and large capital costs. However, there are very few capital markets in developing countries (especially in Sub-Saharan Africa) that are capable of supporting a bond market at present. Efforts to increase the capacity to support local capital markets would be a useful step forward towards allowing more bonds to be issued to raise finance for water projects.

International bond markets are highly liquid, possess huge financing capacity and represent an excellent source of senior debt. However, to use international bond markets to help finance the water sector in developing countries requires:

- A way of protecting investors against the political and financial risks arising on the loans to be made to water projects; and
- A mechanism for aggregating loans. This is because the smallest efficient size for any one issue is approximately US\$ 250 million.

A mechanism for aggregating loans could be stimulated by establishing one or more water funding entities as a pure financing vehicle. These could issue senior debt in the bond markets at competitive rates and on-lend to particular projects. They would operate similarly to the way the multilateral

development banks finance themselves, but without carrying their bureaucratic infrastructure, organisation and cost (other than a capability to satisfy themselves on the credit quality of borrowers and to administer its portfolio of assets, as in the case of the Emerging Africa Infrastructure Fund – see *Annex D* on Building Blocks).

In order to achieve the requisite level of rating for any such funding vehicle from the credit rating agencies, it would need to be supported by:

- Insurance through expansion of the nature of MIGA cover or creation of a dedicated insurance agency with equity provided by OECD Governments, financing its exposure by charging risk premia; or
- The provision of a sufficient level of equity from OECD Governments in the financing entity.

D2.1.13 Debt Swaps

Debt swaps are a mechanism to reduce the debt loads of poor countries in exchange for investment in basic infrastructure services. As many developing countries spend over 50% of their GNP annually on debt payments, debt swaps are a useful way to instigate reform towards sustainable development while increasing capacity to maintain and further the reform process.

As part of the World Bank's Debt Initiative for Highly Indebted Poor Countries (HIPC), which is closely linked with the PRSP process, debt swaps can be a useful means to ensure investments in the water sector. By tying debt swaps to performance-based outcomes including cost recovery and good governance procedures – such as public accounting and increased transparency – donor countries can help shape the environment for reform while improving capacity for sustainable development and increased access to basic services. There is an increasing debate that debt-swaps may be a useful mechanism to raise extra finance for the water sector.

D2.1.14 Equity

Donors (or private sector actors) can choose to take a direct equity participation in water utilities or any other water institutions run on a semi-private basis. As this is long-term financing (with a corresponding share of the costs of liabilities and the benefits of potential upturns), this can provide a solid basis for a utility or institution to invest. A specific form of equity investment is the provision of venture capital, i.e., seed funding for investments, which generally relates to projects that yield a high return. Private utilities would generally be financed via a mix of debt (loans and bonds) and equity finance; and they would seek to optimise their debt/equity ratio in order to make the most of the tax breaks on debt finance. For this reason, high leverage ratios (i.e., high level of debts versus equity) might be preferable up to a certain level where debt finance becomes too expensive because of an increase in the credit risk of the utility.

However, in developing countries, higher levels of equity expect higher returns than would apply in developed markets, because of the higher exposure to political risk (even if formal political risks from expropriation or nationalisation are covered by insurance). This is problematic as tariff levels, often cannot be set high enough to accommodate equity returns at a market clearing level so as to attract the volumes of equity required.

Uncertain GDP per capita growth prospects and the short histories of private utility service provision often discourage equity from taking a view on the future strengthening of affordability and the ability of consumers to absorb these permitted tariff increases.

Furthermore, the use of short-term concession structures serves to discourage interest from potential offshore institutional equity investors who require the benefit of liquidity from shares being listed on a recognised stock market. It is difficult to list concessions carrying large volumes of debt and limited to periods of less than, say 20 years. Hence, the equity a water sector project requires in a developing country often requires an ill-liquidity premium.

Structures can be set up in order to provide equity finance to water operators, which can allow the pooling of funds from both private and public sources. This is an issue that EuropeAid and EIB are currently addressing.

D2.1.15 *Direct Private Investment*

Another way of raising finance for the water sector is to encourage private operators to contribute private investments directly without necessarily contributing equity. This is typically the case in the water sector where the model of “delegated management” has tended to prevail over the divestiture model (leading to equity participation) more prevalent in commercial sectors and other infrastructure sectors. The social and political value of water has made it somewhat difficult for many countries to grant majority share holding in their water institutions to private investors, although partial divestiture is relatively common.

These various forms of private sector participation can bring varying levels of private finance. The highest level of investment requirement for a private investor would be under a concession agreement, whereby the operator needs to invest in long-term infrastructure. In other forms of PSP (say a lease or a service contract), private investment would be limited to a contribution to the costs of short-term investments, such as computer systems or premises.

PPPs and PFIs involve the Government teaming up with the private sector. A privately owned consortium of investors or companies may provide the up front finance for a public investment project (such as a water treatment plant), and the Government agrees to pay back this investment plus an appropriate interest rate over a twenty to thirty year period. Ownership of the asset can also be pledged to the consortia at the end of the payback period. The operation and management of the investment project by the private sector may also form part of the cost structure and pay back agreement.

PPPs and PFIs present a number of advantages with respect to raising finance for the public sector in developing countries. These can include:

- The ability to raise additional finance in an environment of budgetary restrictions;
- Private sector operational efficiencies, which can be harnessed to reduce total costs to the public; and
- The ability to speed up water infrastructure asset development.

The positive characteristics of PPP and PFI arrangements for developing infrastructure and services may become particularly attractive for developing countries, whereby the water service provider can remain in public control, but private sector finance can be raised to help develop it.

D2.2

VOLUNTARY FINANCE

Voluntary finance is a different type of financial source (distinct from purely private or purely public). It can take a number of forms:

- *Contributions.* NGOs of private sector professionals who collect voluntary contributions (solidarity funding) from consumers, e.g., including with utility bills an appeal for contributions to the NGO. For example, water utilities in the UK insert an appeals leaflet into customer bills to make donations directly to Water Aid, an NGO working on water issues out of the United Kingdom. As part of this partnership, the water utilities work with Water Aid to find the best format for the insertion leaflet and cover some of the print costs and all of the insertion costs.⁽¹⁾ This approach is supported in the Camdessus Panel draft report. French NGOs are trying to determine feasibility parameters for a solidarity mechanism to allocate 0.x Euro per m³ of water invoiced to the global development of sustainable access to water. However, the notion of solidarity funding is somewhat controversial, and would have to be voluntary within each member state.
- *Migrant remissions.* Via this form of voluntary finance, expatriates fund local NGOs and/or projects in their region of origin. Migrant remittances

(1) Out of its total budget, WaterAid gets a maximum of 10% through such voluntary contributions.

comprise a large portion both of disposable incomes for families in developing countries, and in aggregate, comprise a significant percentage of a developing country's GNP. These remissions can be either informal, passed from friends and families that visit overseas, or can be channelled through numerous networks and NGOs that have been established for this purpose. Additionally, the influence of expatriates should not be underestimated with regards to consumer education and generating demand for improved service levels and quality.

Some member states advocate more exploration of the possibilities of voluntary finance schemes as ways of helping to raise the extra finance required for the water sector.

D2.2.1 *Sector Wide Approach Programmes (SWAP)*

Used particularly by the European Commission as a way of working together between government and development partners, the aim of a Sector Wide Approach Programme is to:

- Broaden Government ownership over public sector policy and resource allocation decisions within the sector;
- Increase the coherence between policy, spending and results; and
- Reduce transaction costs.

A SWAP involves progressive development of a comprehensive and coherent sector policy and strategy, of a unified public expenditure framework for local and external resources and of a common management, planning and reporting framework.

A SWAP may be supported merely through participation in dialogue and co-ordination and need not involve any transfer of funding to the partner government or other stakeholders within the country. As a result of following a SWAP, governments in consultation with partner donors and other stakeholders may develop an updated sector policy and action plan. This is defined as a Sector Programme, if it includes the following three basic elements:

- An approved sectoral policy document and overall strategic framework (such as a PRSP);
- A sectoral medium term expenditure framework and an annual budget; and
- A co-ordination process amongst the donors in the sector, led by the government.

When funding is transferred, the purpose is to support the Sector Programme or some agreed sub-set of activities within that Programme. The decision on whether to provide funding will depend upon an assessment of the quality of the Programme.

D2.3 ***INFORMATION SHEET D2: DIFFERENT INSTITUTIONAL PROVIDERS OF FINANCE, INCLUDING THE EU OVERSEAS AID COMMUNITY***

D2.3.1 ***Introduction***

This section describes the range of institutions and mechanisms that can help deliver the ways of increasing finance to the water sector as described above.

This Sheet can be used in conjunction with *Step C.3* of the Guidance Note to help identify different providers of finance relevant to the region.

There are many considerations to take into account when choosing a source of finance such as comparative efficiency, administrative costs, effectiveness, and transparency in relation to other options. Financing can either be provided through direct donor assistance or through dedicated financing sources, such as multi-donor initiatives, project preparation facilities, sectoral funds or commercial banks.

The list below is far from being exhaustive, but hopefully provides a basis for reflection about the alternative types of financing sources that can be used in order to provide financing for water most efficiently. In particular, a summary of the aspirations of the family of EU donor institutions (bilateral and multilateral agencies plus European Investment Bank) is provided. This attempts to encapsulate their vision of the nature of their future support.

D2.3.2 ***The EU donor agency family***

Development agencies within the EU comprise of the bilateral agencies of the EU 15, plus Europe Aid (via the EDF) and the European Investment Bank. Although generally concentrated on reducing poverty, each institution has a different set of future objectives and country / water sector priorities. A summary is provided below. As a general observation, very few bilateral EU donors have explicit water sector commitments and strategies in Sub-Saharan Africa, particularly in relation to meeting the MDGs.

D2.3.3 ***EuropeAid***

http://europa.eu.int/comm/europeaid/index_en.htm

EuropeAid comprises of eight Directorates. Five of these directorates manage programmes in specific regions:

- Directorate A is responsible for programmes in Europe, the Caucasus and Central Asia (including Mongolia).
- Directorate B is responsible for programmes in the Southern Mediterranean and Middle East.

- Directorate C is responsible for programmes in the African, Caribbean and Pacific countries (including South Africa and Cuba).
- Directorate D is responsible for programmes in Asia.
- Directorate E is responsible for programmes in Latin America.

Africa, Caribbean and Pacific country funding is derived from the European Development Fund (EDF).

In terms of development strategies, the EC supports various economic, social and human issues, which cover water sector issues including for example, increasing the security of household water and improving access to safe water and adequate sanitation.

D2.3.4 *European Investment Bank*

<http://www.eib.org/lending/acp/en/index.htm>

Within the framework of the EU's external co-operation and development policies, the EIB operates in 77 ACP - African, Caribbean and Pacific - countries. The ACP countries, with a population of some 600 million, have established a special relationship with the European Union through successive conventions; the latest is the 2000 Cotonou Agreement signed in June 2000. In 1998 the Republic of South Africa became an associate member of the EU-ACP conventions. Financing from the EIB in South Africa is provided under a separate bi-lateral agreement.

In 2003-2008, the EIB is expected to channel EUR 3.9 billion to ACP projects, which promote the business sector or to public sector projects if they are operated on a private sector footing. This includes projects in the water and sewerage sector. For this period:

- EUR 1.7 billion will be lent from the EIB's own resources, and
- EUR 2.2 billion will be provided under a new investment facility, funded by EU Member States for private sector support, in particular small and medium sized enterprises, supporting the local savings markets as well as facilitating foreign direct investment.

The investment facility provides various forms of risk sharing financing instruments to most sectors of the economy for projects which are economically, financially, technically and environmentally viable. The investment facility - a revolving facility - constitutes a new long-term financing instrument.

No specific information on investment in the water sector in Africa is given on the EIB website.

D2.3.5 *Austria - Department for Development Cooperation (DDC)*

Information taken from OECD website:

<http://www.oecd.org/EN/document/0,,EN-document-0-nodirectorate-AT-3-8291-0,00.html>

According to a OECD DAC report, one pending issue in the Austrian aid programme is that it still needs an overall strategy binding all the expenditures that Austria considers as ODA to a clear set of development objectives. Currently, Austria's reporting of bilateral ODA includes three components - concessional export credits, assistance to refugees in Austria, and imputed student costs. Although these latter two do not have development as their primary objective, they comprise a considerable amount of total ODA, at 18%. This has been reduced from 55% in 1994. This amount is almost equivalent to the 20% ODA spent for the entire bilateral programme under the Department for Development Co-operation (DDC) within the Ministry for Foreign Affairs (MOFA).

In relation to GNP, Austria has been the leading donor to the Central and Eastern European Countries (CEECs) and the New Independent States of the former Soviet Union (NIS).

After flows from the total ODA budget are allocated to the EC, multilateral institutions, and other priorities as mentioned above, 20% remains for a bilateral programme under the Department for Development Co-operation (DDC) within the Ministry of Foreign Affairs (MOFA). In recent years, the DDC has made real progress in: concentrating project activities and budgets to its partner countries; focusing increasingly on cross-cutting issues; developing aid management tools; and clarifying relationships with NGOs. On the other hand, the quality of its programme is affected by a relatively high number of partner countries; a limited number of country and sector strategies; staffing situation; and a need to mainstream poverty focus at all programme levels.

D2.3.6 Belgium – Belgian Agency for Development Cooperation (BADC)

<http://www.diplomatie.be/en/default.asp>

Belgium assists the following countries in Africa: Algeria, Benin, Burkina Faso, Burundi, The Congo, Ethiopia, The Ivory Coast, Mali, Morocco, Mozambique, Niger, Rwanda, Senegal, Tanzania, Uganda, South Africa and all the countries of the SADC.

Direct bilateral aid is restricted to the following five priority sectors: basic health care; training and education; agriculture and food security; basic infrastructure; and social structure (including conflict prevention).

The available information suggests a more strategic approach to agriculture, social structure and basic healthcare. Little information is provided on the content of 'basic infrastructure', and what this means for the water sector. However, 'environment' is considered a priority theme.

D2.3.7

Denmark - DANIDA

<http://www.um.dk/danida/>

DANIDA is active throughout Africa in the water sector. They are currently undergoing a reorientation of their development strategy. Future strategy of Denmark's bilateral development cooperation will be concentrated on fifteen programme countries according to the will and capacity of the partners to implement a sustainable, poverty-oriented development process based on good governance and respect for human rights.

In practice, the assistance will be distributed between a group of six countries with relatively large and ambitious assistance programmes, first and foremost Tanzania, Uganda, Mozambique, Ghana, Bangladesh and Vietnam, all of which will receive more than DKK 200 million annually in their country framework. In addition to these countries, a group of seven others - Benin, Burkina Faso, Zambia, Egypt, Nepal, Nicaragua and Bolivia - will have annual programmes in the range of DKK 150-175 million. Finally, two programme countries - Kenya and Bhutan - will have quite limited country programmes of DKK 70 million and DKK 65 million, respectively.

The Danish Sector Programme Support Guidelines emphasize that DANIDA can support a sector "if the country concerned has established, or is on the verge of establishing, a set of policies, strategies or programmes oriented to its specific sector". However, it appears that priority will be education and health, infrastructure and the development of a private sector as an engine for growth.

D2.3.8

France - French Development Agency (Afd)

<http://www.afd.fr/english/index.cfm>

<http://www.devinit.org/bilateraldonors.htm>

The French development cooperation system is currently undergoing major reform, with the aid system being refocused around two cores - the Ministry of Foreign Affairs (MFA) and Ministry for Economic Affairs, Finance and Industry (MEFI) - with one main operating agency, the AFD (French Development Agency). An Inter-ministerial Committee, CICID, provides political supervision whilst a newly established Haut Conseil (HCCI) provides civil society input. A new French aid strategy is due to be unveiled soon.

The Afd contributes to growth and combating poverty by helping to finance job-creating projects, through a varied and evolving range of financial products. It works in over 60 countries in Pacific, Asia, Caribbean, Indian Ocean, Mediterranean and South-East Europe, and in Francophone countries. The Afd's operations cover infrastructure, the productive sectors, financial systems and social, education and health projects. In tandem with PROPARCO, the Afd works with the private sector, assisting businesses

with their projects and advising them on other assistance available to support the investment (either from its own resources or from those delegated by other agencies).

The AfD is constantly intensifying its operational collaboration with other bilateral and multilateral funding agencies, particularly through co-financing of projects, partnership agreements and exchanges of staff.

No specific information on the AfD's water strategy for Africa can be found on their website.

D2.3.9 Germany – Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ)

<http://www.gtz.de/english/>

GTZ works extensively in Africa. In terms of water, GTZ state that development cooperation must operate at many different levels:

<p>Water Policy</p> <ul style="list-style-type: none"> • Decentralisation • Privatisation • World Commission on Dams • Public Private Partnership in infrastructure • Global Water Information Network (GLOBWINET) 	<p>Water Resources</p> <ul style="list-style-type: none"> • Transboundary waters • Protection of water resources • Water Resources quality
<p>Drinking water</p> <ul style="list-style-type: none"> • Drinking water quality • Centralised systems 	<p>Wastewater management</p> <ul style="list-style-type: none"> • Centralised systems • Decentralised systems • Ecological sanitation • On-plot sanitation

D2.3.10 Ireland – Ireland Aid

<http://www.gov.ie/iveagh/>

Ireland Aid invests most of its funds directly in programmes and projects in targeted countries. Approximately two thirds of the Ireland Aid budget is allocated for bilateral aid. Six priority or “programme” countries are identified for bilateral aid, which are all African: Ethiopia, Lesotho, Mozambique, Tanzania, Uganda and Zambia.

The Ireland Aid Priority Country Programmes are focussed largely on reducing poverty. They concentrate on trying to meet the basic needs of people such as health care, education, clean water supplies and food security. In addition to the priority countries, bilateral aid is provided for specific projects in a number of other countries such as South Africa and Zimbabwe.

Sub-Saharan Africa continues to be the main geographic focus of the Ireland Aid programme and water and sanitation is a continuing sector focus (but behind health and education which are given very high priority). However no information was found on the Ireland Aid website as to Ireland Aid's specific water strategy for Africa.

In recent years, Ireland Aid has moved away from funding individual projects and towards the funding of long-term programmes based on the development plans of the partner governments. Decisions on whether to establish such programmes are taken on the basis of political, economic and development assessments.

In all six of the programme countries and also in South Africa, the framework for Ireland Aid's bilateral interventions is a three-year Country Strategy Paper (CSP). This document has the status of a formal intergovernmental agreement and is negotiated over a period with the partner government. The partner country must satisfy certain conditions in relation to human rights performance, the quality of governance and other matters. The CSP endeavours to arrive at a shared definition of needs and an agreed programme of action. This approach seeks to increase the partner country's sense of ownership of the programme. It also mirrors to some extent the Irish experience with EU structural assistance.

The country programme is implemented through a number of different instruments. The main emphasis nowadays is on area-based programmes, sector programmes and budget support.

Area-based support is a common feature of country programmes. It is to be found in Ethiopia, Uganda, Mozambique and Tanzania. The ABPs involve Ireland Aid in the provision of assistance in relation to health, education, water and sanitation and dirt roads. They also promote good governance (in particular the building of responsible local government and of an informed electorate). A logical extension of involvement in Area-Based Programmes is the provision of assistance at sectoral level. The engagement at local level helps to identify deficiencies and needs more universally in sectors such as health, education, roads etc. A new area for Irish involvement is budget support, aid that is given directly into the budget of the partner country.

D2.3.11

Italy - Ministry of Foreign Affairs

<http://www.esteri.it/>

and information from:

<http://www.oecd.org/EN/document/0,,EN-document-0-nodirectorate-IT-3-1885-0,00.html>

The Italian government plan to concentrate their efforts in defined geographical areas that include the Horn of Africa, Southern Africa, ex-Yugoslavia, Albania and the eastern Mediterranean.

D2.3.12 *Luxembourg – Agency for Cooperation and Development*

<http://www.lux-development.lu/E/home.htm>

The agency concentrates its work in a limited number of countries, including Namibia, Cape Verde and Niger, Senegal, Rwanda and in a limited number of sectors (health, education, water and sanitation, rural development, environment and the social sector). Its operation appears to be growing, but are limited to projects.

D2.3.13 *Netherlands – Ministry of Foreign Affairs*

http://www.minbuza.nl/default.asp?CMS_ITEM=MBZ257572

The Netherlands has a structural bilateral aid relationship with 22 countries. They are known as structural development partners where Netherlands provides government-to-government support. In Africa these structural development partners include Benin, Burkina Faso, Egypt, Eritrea, Mozambique and Rwanda. The Netherlands works with the governments of another 30 developing countries on one or more themes. These countries are known as policy theme countries. The Netherlands also works with both international NGOs (e.g. the mine clearance organisation Halo Trust) and Dutch NGOs such as Novib and Cordaid.

The Netherlands has a focus on Africa in particular the continent is the joint focus of both the Minister of Foreign Affairs and the Minister for Development Cooperation, particularly the Great Lakes region, the Horn of Africa and Southern Africa (the SADC region).

However an information memo drafted at the request of the Minister for Development Cooperation, Focus on Development study no. 10 concludes that (sector-wide) area development in Africa has produced virtually no sustainable reduction in poverty despite a broad range of activities. This conclusion and the decision to adopt the sector-wide approach have cast doubt on the future of area development within Dutch development cooperation.

On the other hand, a geographical focus within countries may help to strengthen the role of civil society, encourage the process of decentralisation and provide insight into micro-macro relationships. Theme-based co-financing is a system for funding Dutch and international civil society organisations involved in development cooperation. One of the themes for co-financing is drinking water and sanitation.

Although water is not mentioned specifically as a priority policy area, within the 22 target countries for Dutch assistance, the water sector has been selected in 8 (where the bilateral aid is most concentrated).

<http://www.norad.no/>

In 2001, 53 percent of NORAD's net development assistance went to Africa, for a total of 12 countries. 7 of NORAD's 11 priority countries are in Africa (Tanzania, Mozambique, Zambia, Uganda, Ethiopia, Malawi, and Eritrea). Priorities for NORAD are health and education, the former including some water-related issues, e.g., access to clean water projects in Malawi.

The six areas on which development cooperation is focused are: social development; economic development; peace, democracy and human rights; environment and natural resource management; humanitarian assistance in the event of conflicts and natural disasters; and women and gender equality.

NORAD'S partners in cooperation and recipients/beneficiaries of development cooperation are first and foremost the central government and local authorities, civil society (NGOs, cultural communities, research centres and institutions) and the business sector.

NORAD is increasingly taking part in sector programmes based on a coherent strategy for the development of an entire sector, whereby several donors provide financing and technical assistance under the leadership of the authorities of the partner country concerned. In 2001, approximately NOK 107 million was disbursed for six sector programmes, NOK 30 million more than the previous year. There was a similar increase in allocations for budget support, whereby Norwegian aid funds are incorporated into the state budgets of partner countries.

In 2000, broad-based environmental programmes continued in Tanzania, and South Africa. These programmes aim to strengthen the expertise and capacity of the environmental administration. A new project was initiated in 2000 to strengthen capacity in the field of regional management of wetlands in southern Africa, and this project will continue until 2003.

NORAD places particular emphasis on measures to prevent pollution. Many projects focusing on pollution of water and air have been implemented with good results, and in 2000 a study was initiated to find out more about the effects of acid rain. The Norwegian Pollution Control Authority is working with the environmental authorities of Zambia and Mozambique to develop inspection and control routines for industry and expertise in handling hazardous chemicals.

In 2000 NORAD commenced three years of cooperation with the research network START, which is studying anthropogenic climate change and how it affects the environment in the widest sense - and thereby also living conditions on Earth.

Country	Focus
Malawi	Norway will administer aid funds on behalf of both Sweden and Norway in Malawi. Development cooperation will focus primarily on good governance, combating HIV/ AIDS, macroeconomic reforms and strengthening health services.
Zambia	Development cooperation in 2001-2005 would be concentrated on the following areas: good governance, basic education, roads and natural resource management, with the main focus on wildlife
Mozambique	In 2001 Mozambique drew up an action plan for poverty reduction (PARPA), which identifies economic growth, education, increased productivity in family agriculture, employment and improved infrastructure in rural areas as the most important factors for reducing poverty. Norway provides development assistance in accordance with the goals and priorities of this plan.
Tanzania	The new guidelines place particular emphasis on good governance, efforts to combat HIV and AIDS, budget support, and assistance for financial management. There is also emphasis on administrative reform, sector programmes in the field of education and roads, and assistance for natural resource management.
Uganda	Norway's development cooperation with Uganda is based on the country's own poverty reduction strategy, the main goal of which is to reduce the proportion of poor people to ten per cent of the population by 2017. Uganda's own poverty reduction plan has four goals: to create a framework for economic growth and structural change, to ensure good governance and security, to improve the ability of poor people to increase their income, and to improve the quality of life of poor people.
Angola	Under the auspices of the Ministry of Foreign Affairs, guidelines are currently being drawn up for a new approach to Norway's involvement in Angola in the light of the current conflict situation.
Eritrea	Demobilization and reintegration, mine clearance and efforts to combat HIV/ AIDS through multilateral channels will be the main priorities during the transitional period. In the longer term, assistance for good governance, democratic development, basic education and economic reconstruction will be the primary goals of Norwegian aid.
Ethiopia	Assistance has also been provided to ensure sustainable management of natural resources.
Mali	Mali has now formulated a national poverty reduction strategy. The authorities' goal is to reduce the proportion of poor people from 64 percent to 47.5 percent by the end of 2006.
Nigeria	Norwegian development assistance for Nigeria focuses on cooperation in the energy sector (oil, gas, environment) and support for democracy and good governance.
South Africa	The purpose of Norwegian development assistance is to contribute to political stability and social and economic development, in South Africa and in the entire region. There is comprehensive cooperation between Norwegian and South

	African institutions, government agencies and non-governmental organisations.
Zimbabwe	Norway will continue to have a limited presence in the country in order to maintain a dialogue to promote processes of change. Development assistance will be channelled through Norwegian and local non-governmental organizations.

D2.3.15 *Portugal - Institute of Portuguese Co-operation*

Information taken from:

<http://www.oecd.org/EN/document/0,,EN-document-0-nodirectorate-PT-3-1888-0,00.html>

Until recently, Portugal's bilateral ODA was exclusively directed towards the five Portuguese-speaking African countries (PALOPs): Angola, Cape Verde Guinea-Bissau, Mozambique, and São Tomé and Príncipe. Since 1999, there has also been a high level of public support towards East Timor, which has subsequently become the largest recipient of Portuguese bilateral aid.

Portuguese co-operation has been largely based on institutional and personal relationships. The programme is highly decentralised and is spread among 17 ministries and several agencies, universities, and municipalities. The Portuguese Institute of Co-operation (ICP) of the Ministry of Foreign Affairs (MNE) co-ordinates the entire aid programme, as well as carries out policy reviews and evaluations. In 2000, the Portuguese Development Support Agency (APAD) was created to promote Portuguese investment, support social and economic infrastructure, and foster the private sector in beneficiary countries. The instruments to be used are preferential loans, guarantees, equities, and grants whose terms and conditions are still being determined.

Although poverty reduction is one of the major goals in Portuguese co-operation, the aid programme still gives insufficient attention to poverty issues. To concentrate on poverty reduction, Portugal states that it is prioritising support to education and health. However, high proportions of these are allocated to scholarships and individual medical treatments in Portugal, which do not strictly amount to targeting the poor. While Portugal's disbursements toward basic education and health, population, water supply and sanitation remain low, there are signs that this may increase. Furthermore, focus on sector-wide approaches is not yet prominent.

D2.3.16 *Spain - Spanish Agency for International Cooperation (AECI)*

<http://www.aeci.es/>

During 2000, the AECI consolidated its process of focussing on nine African countries: Angola, Cape Verde, Guinea Bissau, Equatorial Guinea,

Mozambique, Namibia, Sao Tome, Senegal and South Africa. The remainder of countries receive cooperation through a limited number of instruments. Mozambique, Equatorial Guinea and Angola receive 77% of total resources destined for sub-Saharan Africa.

The objectives of the AECI in the region have concentrated on basic social needs, especially improvement of the sanitary and educational systems.

The AECI does not appear to provide more detailed information on water priorities in Africa and any information on their strategic vision on their website.

D2.3.17 Sweden - SIDA

<http://www.sida.se/Sida/jsp/polopoly.jsp?d=107>

SIDA has developed a water resources strategy for southern Africa. The initiative is responding to the region's endeavours to achieve sustainable management of water resources. It is initially modest in scope and designed to be catalytic in nature in order to stimulate additional investments in the development of the water resource. The initiative is guided by the four principles for sustainable use of water, endorsed at the Dublin and Rio conferences on water and the environment, and by general Swedish policies on development assistance.

Support to improved water resource management will be focused on two main areas of strategic importance and where limited Swedish financial and technical assistance can have a major impact.

The first area aims at achieving improved planning and understanding of water resources by supporting awareness and capacity building activities among policy and decision makers, students and the general public. Research and development of methodologies for integrated management of water resources is also a part of this area.

The second area aims at better management of water resources partly by supporting environmental surveying and by supporting river basin commissions and their work, jointly set up by the countries sharing a river in an international river basin. Support to the establishment of a Zambezi River Commission can be mentioned as an example of such co-operation under preparation.

SIDA has developed the following water priorities:

- Increasing understanding and spreading awareness
- Legal and incentive frameworks
- Institutional framework and capacity - working within existing institutional arrangements
- Improving information and communication.

D2.3.18 *UK - Department For International Development*

<http://www.dfid.gov.uk/>

DFID state that their efforts are now focussing away from summits, targets and initiatives and more towards ensuring that the international community delivers on its MDG promises by moving to an intensive period of implementation.

Hence, all of DFID's work in relation to water is focused on meeting the Millennium Development Goals for access to safe water and basic sanitation and adoption of national policies and strategies for integrated water resources management in all developing countries, by 2005.

DFID is concentrating on these areas to reduce poverty, increase agricultural production and to promote sustainability. It believes that the contribution of water to poverty reduction will only be realised if it is viewed within the broader context of social and economic development and environmental improvement. Hence it is working now, and will continue to work with development partners, both donors and recipients, to help achieve this goal.

D2.3.19 *Greece*

Information taken from Development Initiatives website:

<http://www.devinit.org/bilateraldonors.htm>

and OECD website:

<http://www.oecd.org/EN/document/0,,EN-document-0-nodirectorate-GR-3-27534-0,00.html>

Greece started its aid effort mainly in the Balkans, Black Sea Regions and Eastern Mediterranean during the 1990s. A very minimal amount of aid is given to sub-Saharan Africa. Greece aims to give 0.2% of GNP in aid by 2001. Responsibility for the aid programme rests with the Ministry for Foreign Affairs. In 1992, a Directorate for Development Cooperation and Special Economic Affairs was set up within this Ministry. The Directorate does not have the overall authority for development cooperation. In addition, departments of the Ministries of Foreign Affairs, Trade, Finance and Education also deal with issues related to development cooperation policy. Inter-ministerial coordination of aid efforts and policy is presently wanting and technical expertise is apparently low.

No specific information has been found on Greek support to the water sector in Africa.

Recently, some EU-based multi-donor facilities with a particular relevance to the water sector have been set up in order to better coordinate their actions and to leverage more private sector finance. In addition to these, the PIDG fund and its initiatives have also been set up to promote private sector participation (see *Section D.3.3.6* and *D3.3.7* for more details).

D2.4.1

Single Sector Trust Funds

Single sector trust funds currently exist to address climate change and carbon emissions, and a study is underway to determine the feasibility of establishing a similar UN Trust Fund for Water. While the advantages of a single-sector fund to prioritise and distribute aid may seem obvious, a concern with single sector trust funds is their lack of integration with general development goals, and their potential to distort the market. Still, within the context of a developing country government's strategy, similar-styled funds have proven quite useful to draw attention to maintain commitments for funding, and to demonstrate medium and long-term investment goals.

A recent and currently evolving initiative with respect to sector funds is the proposal for an EU Water Fund for Africa. This idea consists of a c. € 1 Billion Fund for ACP-countries using the conditional one billion Euros foreseen in the Cotonou Agreement.

Early proposals suggested that the main role of the fund would be to act as a catalyst (promoting initiatives, providing information, being a clearing-house) on the one hand and "the lender of last resort" on the other hand. It would be directed towards achievement of the WSSD and MDG targets and would concentrate its activities in countries, which have a sound national water policy and where indicators are being agreed as part of poverty reduction strategies.

Initial suggestions for the Fund were that it could focus on:

- The co-financing of investments with local authorities and financing institutions;
- Enhancing the 9th EDF "Investment Facility" managed by the EIB;
- Co-Financing and capacity building for EC based projects;
- All forms of technical assistance which contribute to the institutional, social and financial sustainability of the water sector such as:
 - Water policy development leading to sector reform
 - Strengthening and reform of Water utility management
 - Management of transboundary water courses

While the idea of the EU water Fund has generated much interest, at the time of writing discussions are taking place to develop its exact shape and scope and how it may relate to the EU Water Initiative.

A common type of financing source is of course a commercial bank, which can provide debt financing (through loans or the underwriting of bonds) and which can underwrite equity issues. Within the water sector in developing countries, both commercial banks and development banks are involved in these practices.

It is difficult to find comprehensive information on the range of commercial banks with an interest and experience of financing in the water sector. A recommendation could be for this information to be made more accessible. International commercial banks with a track record in this area include Barclays, Standard & HSBC.

There are many current international initiatives, which the EU Water Initiative could link with. They are of various kinds and can have a very different impact on the EU Water Initiative. This Annex provides additional detail on each of these initiatives, under the following headings:

- *Policy initiatives* that shape the way in which development assistance can be provided globally and in the EU;
- *Water-specific policy initiatives*, focusing on the most recent initiatives that form the conceptual basis of the EU Water Initiative;
- *Non-water specific financial initiatives*, which have developed innovative financial vehicles that could potentially be tapped into by the Initiative;
- *Global water initiatives*, which tend to act as knowledge networks and have accumulated considerable expertise on the water sector; and
- *Country-specific water initiatives*, which have been developed by one donor in particular or for a particular recipient country or region.

The summary description of each of these initiatives is followed by a brief analysis of their relevance to the EU Water Initiative, and the way in which they could be working together.

D3.1 POLICY INITIATIVES

D3.1.1 *World Summit on Sustainable Development (WSSD)*

One of the key policy developments driving the EU Water Initiative has been the preparation of the World Summit on Sustainable Development (Rio+10) held in Johannesburg in August-September 2002. Key outcomes of the Summit included:

- Reaffirmation of sustainable development as a central principle, and strengthening of the definition of sustainable development to include linkages between poverty, the environment, and the use of natural resources;
- Governments agreed to and reaffirmed a wide range of concrete commitments;
- Energy and sanitation issues were critical elements of the negotiations;
- Support was given for the support of a world solidarity fund for the eradication of poverty;
- Africa and NEPAD were identified for special attention; and
- Civil society was recognised as having a key role in implementing the objectives, and the concept of partnerships between governments, business and civil society was given a large boost.

The aim for water and sanitation Millennium Development Goal is to halve by 2015, the proportion of people who are unable to reach, or to afford, safe drinking water and undertake a related effort for people without access to improved sanitation.

Agreed actions in relation to this declaration include the mobilisation of international and domestic financial resources at all levels for water and sanitation infrastructure and services development; the development of innovative financing and partnership mechanisms; and an action to integrate sanitation into water resource management strategies.

The EU Water Initiative could complement the efforts of the WSSD by placing water on top of the political agenda and through coordinating with new global financing instruments proposed in Johannesburg.

D3.1.2 The EU/ACP Partnership Agreement (Cotonou Agreement)

The EU/ACP Partnership Agreement defines how development assistance is provided to the 77 ACP (African, Caribbean, Pacific) countries and introduces some guidelines for aid provision. This agreement replaces past Lomé Agreements and is effective for 20 years, with a clause for revisions every 5 years. A corresponding financial protocol indicates the five-year budget available to ACP countries through the European Development Fund (EDF). Currently, EUR15.2 billion in addition to EUR10 billion outstanding funds from previous EDFs are available.

Key features of the EU/ACP Partnership Agreement relevant to the EU Water initiative are:

- Performance-based aid can be provided to NGOs and the private sector without a state guarantee;
- A new investment facility to stimulate regional and international investment while strengthening capacity of local institutions to be set up;
- Explicit recognition of the need for private sector participation; and
- Attention for increasing water security and improving access to WSS.

The Agreement's goal is to promote trade and economic processes that promote regional integration to create economies of scale, promote intra-regional trade to reduce colonial dependencies, and to promote exports through improved access to information and simpler regulations in major export markets. Over time, as these regional areas become stronger economically, the ability to finance projects including water infrastructure may increase. At the same time, tri-sectoral partnerships are promoted, as the private sector and NGOs are provided access to funds for addressing capacity building and participation in the development process. However, the Agreement remains vague about how to involve non-state actors and local authorities. In addition, while the water sector is mentioned as a priority (along with education and health), concrete steps to finance the water sector, or to shift funding to the water sector, are not spelled out. This may be as a result of the Agreement's acknowledgement that initiatives to

use the funding must be demand-driven, and are largely dependent upon the conditions of governance in ACP countries.

The EU Water Initiative has the capacity to increase the profile of water sector investments within the Cotonou Agreement. It could also seek to build upon the proposed investment facility.

D3.1.3

The New Partnership for Africa's Development (NEPAD)

NEPAD is “a pledge by African leaders, based on a common vision and a firm and shared conviction, that they have a pressing duty to eradicate poverty and to place their countries, both individually and collectively, on a path of sustainable growth and development and, at the same time, to participate actively in the world economy and body politic.”

In a document entitled “The New Partnership for Africa's Development”, dated October 2001, a range of initiatives are identified as conditions for sustainable development. The Democracy and Political Governance Initiative includes a series of commitments by participating countries to create or consolidate basic governance processes and practices, while the Economic and Corporate Governance Initiative actions the need to give high priority to public financial management; countries will develop a programme for improving financial management and targets, and assessment mechanisms will also be set in place.

Under sector priorities in the same document, NEPAD looks at ways of bridging the infrastructure gap. It states an objective to increase financial investments in infrastructure by lowering the risks facing private investors, especially in the area of policy and regulatory frameworks. Specifically in relation to water and sanitation, NEPAD states objectives to ensure sustainable access to safe and adequate clean water supply and sanitation, especially for the poor and to plan and manage water resources to become the basis for national and regional cooperation and development.

Clearly, the governance, the financial and the sector priorities of NEPAD could be important cornerstones for the Water Initiative; in particular they can be used to help place its financing option close to the objectives of African Leaders, as stated in their new partnership for development.

African Ministers Conference on Water (AMCOW)

A key output from NEPAD of particular relevance to the EU Water Initiative is the African Ministers Conference on Water (AMCOW). The inaugural meeting of AMCOW was held in Abuja, Nigeria in April 2002. Together with providing a declaration for WSSD, AMCOW identified key sector objectives, many of which relate directly to the Initiative's financing strategy for Africa.

AMCOW objectives:

- Strengthen intergovernmental co-operation in order to halt and reverse the water crisis and sanitation problems in Africa;
- Monitor progress in the implementation of major regional and global water resources and water supply and sanitation initiatives;
- Review progress in the implementation of present international arrangements for the provision of financial resources and technology transfer in support of water sector reforms in Africa. Their review will take into account progress made globally, in the achievement of the water-related goals in both the Millennium and the Malmö Ministerial Declarations;
- Receive and analyse, on a regular basis, reports or information on the adequacy of financial and technological investments in the water and sanitation sector in Africa;
- Consider information provided by African Ministers responsible for Water, for example during the regular sessions of AMCOW, regarding best practices in policy reforms in the water and sanitation sector at the country level;
- Enhance and solidify intergovernmental and regional co-operation in the management of shared waters, including surface and ground water;
- Consider, where appropriate, information regarding progress made or needed in the implementation of intergovernmental agreements on surface and ground water resources;
- Assess and where appropriate adopt best practices in global and regional programmes dealing with water and sanitation; and
- Engage in dialogue and consultations with regional economic groupings and with regional and global financial institutions on issues relevant to the water and sanitation sector in Africa.

The EU Water Initiative can work with NEPAD to develop and implement its African strategy and already considers AMCOW to be a key interlocutor.

D3.1.4

The Environment for Europe Policy Process

An environment programme for Europe (known as “Environment for Europe” process) has been defined through a series of Ministerial Conferences, which have taken place in Dobris (1991), Lucerne (1993), Sofia (1995), and Århus (1998). A fifth Conference of the European Environmental Ministers took place in Kiev in May 2003. The EU Water Initiative EECCA component and environmental financing were discussed.

A strategic objective of the programme is to harmonise environmental policies on the continent, and to secure its peace, stability and sustainable development. At the start of the process, a set of basic guidelines for a Pan-European cooperation strategy was laid out, which include:

- Acknowledgement of a need for intensified cooperation and coordination between countries to protect the environment;
- Introduction of environmental aspects in the process of transition of economies in central and eastern Europe;

- Promotion of environmental considerations by financial and economic assistance; and
- Assistance to improve environment-related health conditions; and Greater responsibility of each country for global environmental problems.

The Lucerne Conference in 1993 was significant for its endorsement of an Environmental Action Programme (EAP) for Central and Eastern Europe. Following endorsement of the EAP:

- A task force (EAP Task Force) was set up to focus on the implementation of policy and institutional aspects of the EAP.
- A Project Preparation Committee (PPC) was set up as a framework to facilitate the identification, preparation and implementation of environmental investment projects in CEE, and improve donor coordination.

These two initiatives are described in greater detail below, under the non-water-specific financial initiatives. Although finance was limited, the European Union and the bilateral donors pledged financial resources on a grant basis to support the preparation and implementation of investment projects that fitted the priorities of the EAP.

NIS Environmental Strategy

In addition, in February 2002, Environment Ministers from Georgia and Ukraine began an initiative to develop a NIS Environmental Strategy. Subsequently, this initiative received support from other NIS countries, as well as from international organisations.

It has been suggested that the Strategy should be aimed at addressing common environmental issues across the NIS on the basis of close co-operation between the countries. The themes to be address by the Strategy include:

- Environmental policy and legislation;
- Pollution prevention and control;
- Natural resource management;
- Integration of environmental considerations into sectoral policies;
- Financial mechanisms, including debt for environment swaps; and
- Environmental information and public participation.

At the fourth Conference held in Århus in 1998, the Ministers decided to strengthen support for the NIS and those countries of CEE that were not part of the European Union's accession process. Environmental financing featured at the Conference as one of the most significant challenges to address. Also, the Ministers agreed to facilitate and support the implementation of effective environmental management in enterprises, and confirmed their willingness to establish a more permanent dialogue with the business community.

The ministerial declaration from the fifth Conference in Kiev has yet to be formally published. However, the water sector is a key component of the declaration, and the role of the PPC and the EAP-Task Force are likely to be restructured in order to try and increase their effectiveness at improving donor coordination and maximizing investment across the environmental sector.

The EU Water Initiative should see the Environment for Europe process as a key interlocutor in the NIS.

D3.2 WATER SPECIFIC POLICY INITIATIVES

D3.2.1 Draft EC Resolution on Water Management in Developing Countries

At a meeting on 13 May 2002, the Members of the EC Development Cooperation Group agreed upon the majority of a text relating to Water Management in Developing Countries. The policy framework for the draft resolution identifies the principle aim of a water sector approach as being to reduce poverty and contribute to achieving the related Millennium Development Goals. It states that water has to be seen as a cross-sectoral issue, to be mainstreamed within development policies associated with poverty reduction, and to be linked to other international agreements or processes.

In particular, the resolution mentions the launch of the EU Water Initiative, for a strategic partnership with the voluntary participation of governments and other stakeholders for the access to safe drinking water and sanitation and sustainable water resources management based on the principle of integrated river basin management. It also mentions the need to strengthen coordination between the Community, EU Member States and other bilateral donors and international organisations, networks and partnerships to identify their comparative advantages in support of national and regional water sector programmes.

Importantly, a key paragraph (15) of the draft resolution was yet to be decided upon, pending developments in the WSSD process. However, paragraph 15 states in its draft form that the Water Initiative *inter alia* will "...promote better governance arrangements, stronger partnerships between public and private sectors and local stakeholders." Good governance is a key factor in the EU Initiative, both for regional cooperation over trans-boundary water sources, and engaging the private sector for increased investments in water and sanitation.

This initiative by the European Commission in the water sector forms the key policy basis for the EU water initiative and should be used as a reference for the accomplishment of its goals.

D3.2.2

The Bonn Recommendations for Action

The Bonn Recommendations for Action emerged from the International Conference on Freshwater, held in December 2001 and involve representatives from government, the private sector, and civil society. ⁽¹⁾

The Recommendations identify priority actions for water-related issues under three headings: governance, mobilising financial resources, and capacity building and sharing knowledge. Financing the water sector was analysed in detail, and five actions were developed and accepted by consensus:

- Ensure significant increases in all types of funding;
- Strengthen public funding capabilities;
- Improve economic efficiency to sustain operations and investment;
- Make water attractive for private investment; and
- Increase development assistance to water.

The Bonn Recommendations are significant in that while they acknowledge the need for public-private partnerships, capacity building, transparency, and strengthening the public sector, they also stress the importance of development assistance and demand-based program approaches, and clearly identify the need for private sector investment. This is a forward step towards coordinated financing for the water sector. After many years of debate over *whether* the private sector should be involved, the debate has shifted to *how* the private sector should be involved, and how to create an environment where the private sector *can* be involved effectively.

The EU Water Initiative can work within the framework established through the Bonn Recommendations to promote sector-wide approaches and more budgetary support and an increased role for private sector participation.

D3.3

NON-WATER SPECIFIC FINANCIAL INITIATIVES

D3.3.1

The Financial Sector Reform and Strengthening (FIRST) Initiative

The FIRST Initiative was launched in April 2002. It aims to provide technical assistance grants to low and middle-income countries for short and medium-term capacity-building and policy development in the financial sector. FIRST is an international initiative jointly undertaken by the World Bank (up to US\$0.5 million), the International Monetary Fund (IMF) and national development agencies - the UK Department for International Development (up to US\$29 million), the International Development Agency of Canada (up to US\$7.5 million) and the State Secretariat for Economic Affairs of Switzerland (up to US\$8 million).

(1) This built on principles elaborated in the landmark Second World Water Forum, held in the Hague in March 2000 under the leadership of the World Water Council.

FIRST is designed to act as a catalyst for longer-term support from traditional bilateral and multilateral donors. Project results in one country under the FIRST initiative will be used or adapted in others, saving money and providing developing countries with a much more coordinated approach to financial sector assistance. In addition, FIRST will play a key role in the co-ordination of donor activity in the financial sectors of developing countries by establishing an information exchange on the delivery of financial sector technical assistance in developing countries.

Its scope includes:

- Financial system reform
- Financial sector legal, regulatory and supervisory frameworks
- Banking systems
- Capital markets
- Payment systems
- Corporate governance
- Accounting and auditing
- Insolvency regimes
- Debt markets and management
- Insurance/other collective investment schemes, including pensions
- Market integrity and financial crime (anti-money laundering)
- Financial systems diversification (development of non-bank financial institutions and new market instruments)

FIRST will support activities and interventions mainly in the public sector (primarily technical assistance to policy makers and regulatory bodies) but will also support private sector activities where organised through capital market institutions such as stock exchanges, self regulatory organisations and relevant associations or institutes (e.g. of brokers, bankers or insurance companies).

The EU Water Initiative can actively communicate with FIRST to keep abreast of and support successful reform within the public-private sector arena of water-related investments.

D3.3.2

Public-Private Infrastructure Advisory Facility (PPIAF)

PPIAF is a multi-donor technical assistance facility aimed at helping developing countries improve the quality of their infrastructure through private sector involvement. PPIAF was established in 1999 at the initiative of the governments of Japan and the UK, working closely with the World Bank. PPIAF is owned and directed by participating donors, including bilateral and multilateral development agencies and international financial institutions.

PPIAF finances country-specific and multi-country advisory and related activities in framing infrastructure development strategies to take full advantage of the potential for private involvement, building consensus for appropriate policy, regulatory, and institutional reforms, building

government capacity in the design and execution of private infrastructure arrangements and in the regulation of private service providers and supporting the design and implementation of pioneering projects and transactions.

PPIAF utilizes a core fund which consists of untied funds that can be used for any PPIAF project and are not subject to donor restrictions, and a non-core fund which is subject to donor restrictions. In 2002, PPIAF funded activities for a total value of \$13.3 million. Sub Saharan Africa accounted for 39% of funding, and the water and sanitation sector received 23% of the total funding.

The EU Water Initiative can act in areas where reforms have been successfully implemented, and work to leverage public sector funds for additional private sector participation.

D3.3.3 EAP Task Force for CEE/NIS

In 1993, European Environment Ministers established a Task Force to assist the countries of CEE and the NIS in:

- Integrating environmental considerations into the process of economics and political reform;
- Upgrading institutional and human capacities for environmental management;
- Broadening political support for environmental improvement; and
- Mobilising financial resources, and their cost-effective use.

Since 1998, EAP TF centre of attention has been gradually shifting towards the Newly Independent States, and those countries in CEE that are not part of the pre-accession process. Currently, the EAP Task Force focuses its work on the following main elements:

- Implementation of environmental policies and national environmental action programmes (NEAPs);
- Environmental finance;
- Urban water sector reform;
- Public involvement on environmental decision making; and
- Assistance in the development of NIS Environmental Strategy.

Urban water sector reform in the NIS is one of the priorities of the Task Force. This theme was launched officially at a meeting of NIS Ministers of Economics/Finance and Environment, Ministers and senior representatives from several OECD countries and IFIs in Kazakhstan in 2000, with approval of the Almaty Guiding Principles for reform of the urban water supply and sanitation sector in the NIS. Subsequently, the Group of Senior Officials on Urban Water Sector Reform in the NIS was established in September 2001, which comprises NIS, OECD, and CEE water officials, IFIs, private sector and NGOs, and promotes political support to reforms in water sector.

The EAP Task Force is co-chaired by the European Commission, and its Secretariat is located at the Environment Directorate of the OECD in Paris.

The EU Water Initiative should seek to draw from the knowledge base developed by the EAP Task Force and use its network as a relay.

D3.3.4 *The Project Preparation Committee (PPC)*

The Project Preparation Committee (PPC) is a networking mechanism established in 1993 to improve coordination and cooperation between IFIs, donors and countries in transition to facilitate environment related investments in CEE and the NIS. The PPC Secretariat is based in London at the EBRD, with officers designated to implement the PPC mandate located at the EBRD and the World Bank.

The PPC works by trying to ‘match’ donor grant funds for investment support or technical assistance to potential IFI loan finance for environmental projects, which have been given priority in this region and which fit the priorities of the EAP. Hence, the PPC is not a fund, a clearinghouse or a mechanism to evaluate projects. It deals only with projects co-financed by donors *and* IFIs, and does not deal with projects of a national or bilateral nature.

Project proposals are submitted by the National Government through normal channels to the IFIs or the bilateral donor. After the Central and Eastern European partner and the donor or bank have agreed on the contents of the project and the co-financing needed, the project can be presented to the PPC by one of the donors or IFIs that constitute the PPC.

PPC donors contribute to the PPC in several ways. For example, they provide:

- Grant aid to the countries of central and Eastern Europe and the NIS in preparing projects before they are submitted to the IFIs for consideration;
- Support for technical assistance aimed at institutional strengthening and policy development, a prerequisite for the implementation of sound investment projects;
- Support for technical assistance for projects on which IFIs are working. This can be done by specific PPC ‘trust funds’ established at the IFIs (e.g. by Japan, the Netherlands and by Switzerland), by specific contributions through bilateral assistance, or through other established mechanisms (such as general consultants ‘trust funds’);
- Co-financing for environmental investment projects. Donors can finance projects jointly or co-finance with IFI loans in the form of joint financing or parallel financing; and
- Funding for staff (PPC officers and PPC Secretariat) is primarily based at the EBRD and the World Bank.

Since its creation, the PPC has been effective at minimising the “revolving door” problem suffered by recipient country governments, when faced with

a host of enthusiastic donors in the environmental sector. It has also allowed the finance available for environmental projects to be used more effectively, rather than necessarily leveraging in more money in total.

The EU Water Initiative should seek to build on the PPC for a better preparation and selection of projects and could seek to adapt this mechanism to other priority regions, particularly Africa.

D3.3.5 *Joint Environmental Programme (JEP)*

The Joint Environmental Programme (JEP) is an effort by the European Commission's Tacis programme and the World Bank to work together to help the New Independent States and Mongolia mobilise investment in the environment sector. JEP uses Tacis funding to carry out feasibility and preparation studies for selected investment projects being considered by the World Bank (and other IFIs). These projects can be fully environmental (e.g. cleaning up a polluted site) or be energy and infrastructure projects with a strong environmental component (e.g. building a water treatment plant).

The projects submitted for JEP funding must meet several criteria:

- Their positive impact on the environment must be significant;
- They must contribute either to the implementation of each country's National Environmental Action Plan (NEAP), or to a great improvement in the way natural resources are managed;
- National institutions must be capable of handling issues related to the project, but its cost must exceed local financial means;
- Projects should appear in the World Bank's Country Assistance Strategy or at the very least be essential to achieve this Strategy. This means that even projects proposed by Tacis must be added to the Country Assistance Strategy before they can be considered for JEP funding.

It is thus essential that a project forms part of the World Bank's Country Assistance Strategy. A project cannot be considered for JEP financing unless the World Bank has included it into its overall strategy for a country.

The EU Water Initiative should seek to build on the JEP for a better preparation and helping the financing of feasibility studies for potential projects and could seek to adapt this mechanism to other priority regions, particularly Africa.

D3.3.6 *Private Infrastructure Donor Group (PIDG)*

PIDG is a planned multi-donor fund for the development of financial instruments for private sector participation in infrastructure. Current members include Holland, Sweden, Switzerland, and the UK, although other grant donors have also expressed interest in joining. The fund's structure aims to promote private sector participation while building the financial capacity of local governments to be active partners in a project. It is expected

that water and sanitation investments will play a key role in each of these components.

The following are proposed structures that will contribute to PIDG:

An Infrastructure Development Company (DevCo). This would be a project preparation facility seeking to develop potential infrastructure projects to the point where they can be offered to private sector companies on a transparent, competitive basis. Implementation would be by the private sector alone or (commonly) working in partnership with other stakeholders in-country. Successful bids would be charged a levy to recover operating costs.

A Development Guarantee Company (GuarantCo). This proposes to provide partial risk guarantees for local currency bonds issued by municipalities and utility companies for infrastructure works, and to offer to put operations to local banks for loans to municipalities and utility companies for infrastructure works. Feasibility studies for GuarantCo were undertaken in mid-2002, and the company was recently formed.

In addition, PIDG is a key player in the Emerging Africa Infrastructure Fund (EAIF) described below.

The EU Water Initiative could collaborate with PIDG to support good project preparation, and to replicate successful projects elsewhere.

D3.3.7 Emerging Africa Infrastructure Fund (EAIF)

EAIF is a public-private financing partnership initiated by the UK DFID in 2002 that aims to create a long-term harmony between the developmental and commercial objectives of the public and private sector for the benefit of sub-Saharan Africa's economic development. It is financed by grant donors, and offers competitive long-term lending terms to significant infrastructure companies throughout sub-Saharan Africa, with the expectation to increase private investment to levels that are competitive for long-term investments of up to 15 years by reducing risk and providing guarantees.

The majority of lending will be US\$ based, although guarantees to local banks to facilitate local currency lending may be available where this is beneficial. Currently, EIAF has US\$305 million in initial financing. DFID is combining with other European donors to provide additional capacity to enable EIAF to grow to around US\$450 million on a similar level of gearing.

EIAF will consider a wide range of opportunities including green-field developments, privatizations, refurbishments, upgrades and expansions with particular emphasis on:

- Power generation, transmission & distribution;
- Telecommunications;
- Transportation; and
- Water (supply, distribution, treatment/purification, etc.).

Within these opportunities, no one sector is to account for more than 40% of the portfolio, and there is a country limit of 25%. A goal to be active, via at least 10% of exposure in each eligible sector has also been identified.

The EU Water Initiative, particularly the Africa component, could consider linking with the EIAF, with a focus on water.

D3.3.8 Public Private Partnerships for the Urban Environment (PPPUE)

Established in 1996 with support from Switzerland, New Zealand and the UK, PPPUE brings together government, private business and civil society to pool resources and skills to improve basic services at local levels, with an overarching goal of developing tripartite partnerships. Focusing on small and medium size cities, PPPUE works with all potential stakeholders including investors, providers, regulators, users and experts to meet the challenge of providing basic urban environmental services. PPPUE maintains a flexible financial structure that allows donors to contribute to the PPPUE Trust Fund in general or for specific activities.

The PPPUE Innovative Partnership Grants support projects and activities in establishing adequate policy, legal and institutional frameworks for public private partnership development at local level, building local capacity for public private partnerships and designing and implementing innovative partnership arrangements.

The EU Water Initiative could scale up this initiative, and share lessons learned from institutional reform.

D3.3.9 Community-Led Infrastructure Financing Facility (CLIFF)

The Community-Led Infrastructure Financing Facility (CLIFF) is a joint Cities Alliance, DFID, USAID, SIDA and Homeless International initiative to help slum dwellers to improve their access to private finance for housing and associated infrastructure services and leverage otherwise under-utilised public funding. CLIFF supports communities in developing business plans for the funding and cost-recovery of locally initiated housing and infrastructure projects, in taking these plans to local banks or development finance institutions, and provides an international guarantee against repayment from revenues, thus facilitating a sustainable service and ensuring that the risk is shared. The first programme is underway in India, following which further pilots will be undertaken in Kenya and other Sub-Saharan countries.

Specifically, at the local level, CLIFF will

- provide bridging loans, guarantees and technical assistance, both local and international, to initiate medium scale urban rehabilitation in cities in the developing world;
- work in partnership with community based organisations that have a track record in delivery of urban rehabilitation; and
- seek to attract commercial, local and public sector finance for further schemes thus accelerating or scaling up the response to the challenge of urban renewal.

CLIFF proposes to address the financing gaps that exist for infrastructure by:

- financing development of pilot and demonstration projects;
- financing initial scaling up;
- financing risk management and mitigation; and
- financing learning, knowledge creation and partnership capacity building.

Financial support will be in the form of initiation finance, through loans for municipal housing/infrastructure projects, and financial guarantees to leverage commercial and social funds from traditional sources.

The EU Water Initiative could help to scale up CLIFF's efforts, through assistance in developing the role and financing of water and sanitation improvements, along with supporting CLIFF-initiatives in Africa.

D3.4 GLOBAL WATER INITIATIVES

D3.4.1 The Global Water Partnership

The Global Water Partnership (GWP) is a worldwide network of partners, which promotes and facilitates the exchange of knowledge and experience in the management of water resources. The goal of the GWP is to work towards 'water security' for all - that every person has access to enough safe water at affordable cost while ensuring that the natural environment is protected and enhanced. Of particular interest to the Water Initiative are the GWP's Dialogue on Effective Water Governance, and their Panel on Financing Water Infrastructure (the "Camdessus" panel - discussed in greater detail in *Section C1.4.3*).

Dialogue on Effective Water Governance

The GWP's Dialogue on Effective Water Governance is pertinent to the Initiative, as it suggests that governance issues are a prerequisite for the successful implementation of Integrated Water Resources Management. GWP defines water governance as the range of political, social, economic and administrative systems in place to regulate the development and management of water resources and provision of water services at different levels of society. The Governance Dialogue sets out to enable institutions and institutional arrangements for IWRM, through:

- Facilitating communication between politicians and other decision makers, water managers and users;
- Highlighting good practice and lessons learned in implementing IWRM; and
- Developing an IWRM toolbox.

Outcomes of the Dialogue were fed into WSSD and the Third World Water Forum in Kyoto, Japan, held in March 2002.

The EU Water Initiative could assimilate the outcomes of the dialogue to its financing strategy, in order to strengthen the Initiative's governance and IWRM components, and build on its results.

D3.4.2

The World Water Council (WWC)

The World Water Council is the International Water Policy Think Tank dedicated to strengthening the world water movement for an improved management of the world's water resources. The World Water Council was established in Marseille, France, in 1996 as a non-profit non-governmental umbrella organization. The missions of the World Water Council are to promote awareness and build political commitment on critical water issues at all levels, including the highest decision-making level, to facilitate the efficient conservation, protection, development, planning, management and use of water in all its dimensions on an environmentally sustainable basis for the benefit of all life on earth.

Its specific objectives are:

- To identify critical water issues of local, regional and global importance on the basis of ongoing assessments on the state of world water;
- To raise awareness of critical water issues at all levels of decision making;
- To provide the platform to arrive at a common strategic vision on integrated water resources management on a sustainable basis, and to promote the implementation of effective policies and strategies worldwide;
- To provide advice and relevant information to institutions and decision-makers on the development and implementation of comprehensive policies and strategies for sustainable water resources management, with due respect for the environment, and social and gender equity; and
- To contribute to the resolution of issues related to trans-boundary waters.

To fulfil its missions and objectives, the World Water Council has created the World Water Fora which, accompanied by a Ministerial Conference, is a major water event organized every three years in close collaboration with the authorities of the hosting country. The second World Water Forum was held in the Hague in March 2000 and the third was held in Kyoto in March 2003.

The EU Water Initiative should seek to collaborate with the World Water Council.

D3.4.3 *The Panel on Financing Water Infrastructure*

The Panel on Water Financing is an important initiative from the GWP and the World Water Council. Its aim was to examine the financing challenges facing the water sector, especially in relation to meeting the Millennium Development Goals. The Panel included representatives from all of the major IFIs, private businesses including banks and water supply companies, and several poverty-related NGOs such as WaterAid, Transparency International, and the International Secretariat for Water. The Chairman of the Panel was M. Michel Camdessus, formerly Managing Director of the International Monetary Fund and now Honorary Governor of the Banque de France.

The Panel had seven full meetings, in Manila, Washington, Johannesburg, The Hague, Paris (twice) and London. The Chairman and other panel members also went to other key water conferences and gatherings. It heard evidence from a wide range of people from different parts of the water and financial sectors across the world. Its report was presented to the Third World Water Conference in Kyoto in March 2003.

The Panel identified the following constraints facing the water sector:

- Low rate of returns in water investments;
- Foreign exchange risks (local currency revenues mismatched with foreign currency financing);
- Sub-sovereign risk (decentralised agencies lack financial resources and credit ratings);
- Political pressures (on contracts and tariffs); and
- Contractual risk (poor initial formulation of long duration projects – e.g. high legal costs for small scale projects).

It drew the following conclusions based on these constraints, and suggested a number of potential solutions:

- Sustainable cost recovery through more internal funds and stable framework for revenue transfer is essential;
- Banks and private sector more aware of risk-reward trade-off;
- Aid should be well targeted and simulate flows from other sources (esp. local); and
- Foreign exchange risks are a key disincentive in attracting international loans and equity in emerging markets.

The full report can be found at <http://www.gwpforum.org/servlet/PSP>.

As part of the proceedings of the Panel an earlier draft of this paper was requested for submission. Consequently, the work of the Finance

Component of the EU Water Initiative and the findings of the Panel are closely related.

The EU Water Initiative has drawn on the research presented by the Panel to inform its own decision-making, and each component should build on the recommendations made in the report.

D3.4.4 *The Water Supply and Sanitation Collaborative Council (WSSCC)*

The Water Supply and Sanitation Collaborative Council is an international organisation that enhances collaboration in the water supply and sanitation sector, specifically in order to attain universal coverage of water and sanitation services for poor people around the world. WSSCC is in essence a hybrid professional association and international NGO. It operates with a mandate from the United National General Assembly.

The main mechanisms that the Council adopts to achieve its objectives are:

- A series of global and regional fora, typically held every 2-3 years;
- Between fora, working groups, task forces and networks focus on selected developmental issues; and
- A key WSSCC working group called the Institutional and Management Options Working Group (IMO-WG).

IMO-WG

The IMO-WG was given the mandate to analyse, document and disseminate case studies on different institutional arrangements and management practices. Hence, the IMO-WG has concerned itself with the institutional and management options that prevail in the water supply and sanitation sector with specific reference to water demand management.

The IMO-WG did have a focus on delegated public management options for water (the “French” mode of PSP). However, the focus of the group has evolved over time and it now has four key objectives for the coming years:

- To make an inventory of institutional options for wastewater and sanitation;
- To analyse incentives for utilities to serve the urban poor;
- Private sector participation in small and medium towns; and
- To analyse institutional reform related to labour policies.

For each of these study areas, research is underway. Of particular interest to the EU Water Initiative may be a study that reviews the institutional options in water supply and sanitation, in particular related to the average utility and municipality, and how these could be encouraged to work in partnership with NGOs, communities and other private providers. Another relevant research goal is to identify appropriate and applicable PSP solutions for small and medium towns.

The EU Water Initiative could develop a partnership with the WSSCC, and in particular for the IMO-WG studies to build on existing knowledge and documents.

D3.4.5 *The Water and Sanitation Program (WSP)*

The WSP is a worldwide network operating in over 30 countries that works with governments, donor agencies and NGOs to promote solutions and influence policy related to helping poor people gain sustained access to improved water and sanitation services.

The WSP is managed through a head office in Washington, D.C. and four regional offices in South Asia, East Asia and the Pacific, Africa, and the Andean Region, and is positioned within the World Bank.

Over the past two decades, the WSP has demonstrated success in helping its clients improve access to water and sanitation services for millions of poor people in rural and urban communities. It has led or supported many of the advances made in the sector in recent years, and has actively contributed to the growing understanding of how to translate guiding principles agreed upon at major international conferences into actual improved policies and programs. WSP sees the current challenge as being to scale up successful approaches, continue targeted learning efforts, and support reforms that will ensure the adoption and replication of sustainable investments.

WSP focuses on three mutually supportive outputs:

- Policy, strategy, and institutional reform advisory services;
- Innovative solutions to water supply and sanitation problems; and
- Strategically selected investment support services.

These outputs are derived from five types of WSP products: policy support, support to investment projects, pilot and demonstration projects, sector networking, and knowledge sharing (learning events, case studies, and field notes).

D3.4.6 *WSP - Africa*

In Africa, WSP identifies the following challenges:

- To use limited public sector financial resources as efficiently and effectively as possible, in order to leverage reforms.
- To use the dominance of external resources in most WSS funding as an opportunity to link water sector reforms to investments within the local PRSP framework.
- To recognise that decentralization policies, which have emerged as a key policy in most African countries, are the context within which WSS reforms need to be placed.

WSP-AF has been a regional leader in Africa, supporting countries to develop appropriate WSS-related strategic interventions, including development of WSS policy and reforms, implementation models and strategies and support to investment projects and pilots. WSP-AF sees itself as having a key role to play within the area of water, PRSP and financing strategies.

WSP-AF's regional finance and PRSP strategy involves producing two broad groups of product:

- Strategies on the assessment of resource flows, subsidies, support to PRSP preparation and implementation, and a regional finance strategy for Sub-Saharan Africa, and
- Finance mechanisms related to social funds and micro-finance.

Over the past several months, WSP-AF has started to pursue a suite of projects, which could be of much use and interest to the Water Initiative and its financing strategy for Africa.

- *Assessing Resource Flows and Restructuring Subsidies*: WSP-AF plan to develop a framework to identify financing arrangements; assess resource flows; and look at the nature of subsidies and the manner in which these need to be restructured in line with sector reforms, in order to maximise local incentives for stimulating water and sanitation investments. The work has recently begun in Kenya, but the issue of data availability is proving to be a challenge, especially in relation to identifying and tracking post-budget financial flows in the public sector. One clear finding to emerge from the work so far is the level of dependency on external funding for water in Kenya – external donors support approximately 70-80% of the water and sanitation sector. This creates a challenge if instruments such as credit, micro-finance and savings mechanisms are to be fostered to help finance the sector.
- *Regional Financing Strategies (Decentralization and WSS Financing)*: This will be a global review, including Africa to create an issues paper for financing water and sanitation, in the context of status of sector reforms, preparation and implementation of PRSPs and level of financial sector development in different countries. It will be developed based on secondary sources of information. A draft is due in October 2002, and it will form the background paper for a regional workshop on “PRSPs and Regional Financing Strategies” planned towards the year-end. Three broad sets of options will be looked at in the review. These include:
 - Those linked to decentralization linked fiscal mechanisms largely through the traditional public finance systems linked to budget allocations, and comprising conditional grants and fiscal transfers;
 - The use of special fund linked mechanisms at local, regional, national and global levels, with autonomous governance and

- institutional models, often developed independently of the regular government financing arrangements; and
 - More recent approaches in funding mechanisms structured within programmatic approaches, including a variety of program linked financing arrangements.
- *WSS in Social Funds - assessment, lessons learned and guidelines:* This activity draws on the WSP experience in supporting water and sanitation in social funds in Mali, Malawi and Ethiopia. Early findings from *Ps-Eau* indicate that social funds for water are not as effective as those for health and education. It seems that social funds for water could be both better linked to the PRSP process and benefit from institutional reform and capacity building within the sector.
- *Micro-finance and WSS - industry assessment and WSS potential:* A rapid assessment of micro-finance in Africa and its current and potential interest to the water and sanitation sector was recently completed. Draft findings suggest that the market for WSS is fast evolving with the emergence of a range of providers including commercial utilities, small-scale independent providers and community based NGO initiatives. There are significant challenges, however, in finding cost effective and sustainable solutions to the operations and maintenance of WSS, as well as the cost recovery of investment costs. These challenges may include, on the demand side, low investment capital among poor communities to contribute to capital costs; low purchasing power of poor households to pay for delivery and maintenance costs; negative price elasticity of demand given free alternatives; low priority given to water and sanitation expenditure, particularly if free alternatives exist. And on the supply side, there is a subsidy mentality prevalent among NGO/CBO and Government providers, which does not provide an incentive to promote community/household financing.

The EU Water Initiative should draw from ongoing projects that analyse financing strategies and in particular examine the role of micro-finance for the water sector in Africa.

D3.4.7

The Business Partnerships for Development (BPD)

Business Partners for Development (BPD) is an informal network of partners that seeks to demonstrate that partnerships involving business, government and civil society can achieve more at the local level than any of the groups acting individually. The approach may present a successful way toward sustainable development in communities around the world.

BPD's Water and Sanitation Cluster aims to improve access to safe water and effective sanitation for the rising number of urban poor in developing countries. By working in partnership with the public and private sectors, and civil society, it is presumed that governments can ensure the health of their citizens with safe water and effective sanitation while apportioning the financial and technical burden; the private sector can effectively meet their

contractual obligations while ensuring financial sustainability over the long term; and communities can gain a real voice in their development.

The Water and Sanitation Cluster worked with eight focus projects around the world, most of which predated the Cluster. The approach to extracting information from which to analyse the efficacy of tri-sector partnership was three-pronged: 1) by supporting partnership-oriented research on thematic project elements (cost recovery, education and awareness, etc.); 2) by creating forums for analysing the sector specific (civil society, public and private sector) benefits and challenges of working so closely with organisations from other sectors; and 3) by documenting the evolution of the partnership in specific focus projects.

The BPD Water Cluster Focus Projects included three in Africa:

- Sustainable water and wastewater services in underprivileged areas, Eastern Cape and Northern Province, South Africa;
- Management of water services, Durban and Pietermaritzburg, South Africa; and
- Upgrade and expansion of local water networks, Dakar, Senegal

The first phase of the BPD water cluster ended recently. This allowed some key issues to be distilled, especially in relation to the complex and unique make-up of the different tri-sector partnerships examined in the case study projects. The next stage of the BPD water cluster work will be to build upon the lessons learned in order to help nurture, support or advise further tri-sector partnerships that are emerging (or could be stimulated) as part of other water related initiatives. This will mainly be achieved through the provision of training and capacity building services, and the provision of a long-term advisory facility.

The EU Water Initiative could draw upon the knowledge gained on a range of issues including cost recovery, regulatory systems and relationship building through tri-sectoral partnerships, especially in relation to the role of civil society in a public-private financial mix. Additionally, the EU Water Initiative could consider scaling up this initiative through additional involvement.

D3.4.8

The Water Utility Partnership (WUP)

The Water Utilities Partnership (WUP) for Capacity Building is a partnership organisation founded by the Union of African Water Suppliers (UAWS) and the International Training Network Centres in Africa – CREPA and TREND. Following a consultative meeting on institutional reform in the Water Sector held in Johannesburg in 1996, WUP was established to address key challenges facing utilities and their partners in the region. The primary constituency for WUP is the Union of African Water Suppliers (UAWS), a membership association of utilities in Africa. The Union brings together utilities from a large number of countries throughout Africa. WUP implements a range of projects in partnership with other actors in the region

and with support from bilateral and multilateral agencies, for example to develop arrangements whereby utilities compile and share performance data and to develop an understanding of how such data can be used for benchmarking.

D3.4.9

WUP Toolkit

A key challenge identified by WUP is the need to identify ways of improving water supply and sanitation service delivery to low-income urban communities. A toolkit has been developed to assist utilities to understand and address the water and sanitation requirements of low-income communities. Information contained in the toolkit has been collected through wide consultation and case study in nine countries within Africa.

The toolkit has a section on financing and cost recovery for water service projects aimed at low-income users in Africa. Core issues such as establishing a pricing policy, setting prices for services in low income communities, establishing financing mechanism and setting up payment systems are addressed in some detail.

To increase the levels of finance attracted to water and sanitation services to the low-income urban poor, the WUP toolkit suggests some key actions:

- Improve viability of utilities and strengthen their mandate to invest in low-income areas. Address investment risk, for example by negotiating with local authorities on the security of the infrastructure and developing payment systems suitable to the circumstances of the customer;
- Expand the range of financing mechanisms (funds, taxes, surtaxes, grants);
- Establish credit schemes for sanitation, perhaps managed independently, and linked to a sustainable financing mechanism. Finance options may include government grant funding for household sanitation systems;
- Recognise and institutionalise investments made by alternative providers;
Review policies for sanitation to improve collaboration or reform institutions to allow joint management or unify the management; and
- Establish credit/subsidy mechanisms for connections, installations, condominial or group extensions of water and sewerage.

The EU Water Initiative could use this suite of actions to increase financing as a useful starting point for exploring financial mechanisms to extend water investments to low-income areas, and build on this organisation to identify good projects in Africa. Additionally, the WUP's stakeholder group could have a role in implementing the Initiative in Africa.

D3.4.10

The World Bank Water Resource Management Group

The World Bank Water Resources Management Group is another important initiative related to integrated water resources management. In March 2000, the World Bank formalised a Water Resources Management Group (WRMG) within the Bank. The members of the WRMG are the managers or lead specialists from stakeholder sectors (water and sanitation, hydropower, irrigation and environment), the lead water resource specialist from each region, the water leaders from the World Bank Institute, IFC, and the GEF Secretariat, as well as a representative from the Legal Department.

Given the cross-network nature of its work, the Group collaborates closely with other Sector Boards of the World Bank, such as Environment, Rural, Water and Sanitation, and Energy. The mandate of the WRMG encompasses:

- Quality of the World Bank's lending and analytic work on water resources;
- Human resource actions with respect to water resources management, working collaboratively with various sector boards;
- Outreach and corporate positions on water resource issues; and
- Knowledge management on water resources.

As part of its work, the WRMG is engaged in a number of water partnerships aiming at jointly developing new and innovative approaches to sustainable water resources management. Partners include the Government of the Netherlands (see below), the GEF, the IUCN, the World Wide Fund for Nature, the Global Water Partnership, and the World Water Council.

Recently, the WRMG has been developing a new Water Resources Sector Strategy, which has included consultations in Brazil, Philippines, Yemen, Nigeria, the US and Europe and with representatives of donor governments, NGOs and the private sector.

The EU Water Initiative could develop a similar water resources strategy, but building a specific EU line on water issues. It should also investigate potential partnerships with the World Bank, in line with what has been done by the Netherlands.

D3.5

COUNTRY/REGIONAL WATER INITIATIVES

D3.5.1

The African Water Facility

Supported primarily by the Dutch Development Agency, the African Water Facility (AWF) was conceived at a series of meetings and dialogues that have taken place over the last few years as a stepping-stone to meet the targets and goals for the water sector that were established by the African Water Vision and the Millennium Development Goals (MDGs). It was launched at the Third World Water Forum in Kyoto, March 2003. The AWF also aims to take advantage of the momentum that has been growing politically, through initiatives such as the New Partnership for Africa's Development (NEPAD),

the African Ministers Conference on Water (AMCOW), and the African Water Task Force (AWTF).

The primary objective of the AWF is to provide investment support for water resources management and water service provision in Africa. It aims to raise multi-donor and other funds to provide:

- A grant facility aimed at preparing projects and programmes and facilitating investment; and
- An investment facility to provide loans to finance strategic projects and programmes which would catalyse additional investments.

It is envisaged that the African Water Facility will operate through a number of different windows, providing:

- Grants for Sub-Regional and Trans-boundary Water Resource Management Program Development;
- Grants for National Level Reforms, Strategy Plans and Legislation: This would provide incentives for and support to those governments that propose to implement sector reforms through necessary legislation amendments and institutional reforms. Grants would support activities such as: cost of developing the reform program, meeting initial labour costs of rightsizing central ministry and local authority staff structures, or the costs of safety nets or easing the political costs of tariff reforms and of well-targeted subsidies for the poor in the context of local tariff reforms. A specific focus of grants would be to assist countries incorporate water more centrally in national poverty reduction strategies;
- Budget Support for Water Investments: This window will provide budget support to countries, where political commitment is high, the policy framework adequate and where there is an appropriate institutional structure, for water sector operations through a loan-grant mix;
- Grant to Establish a Benchmarking and Monitoring Facility: this would provide comparative performance assessment for all African countries on agreed performance indicators to assess: a) level of country commitment on IWRM and WSS sector reforms, b) progress on implementation of IWRM and WSS sector reforms, both institutional, financial and coverage, c) overall country framework for fiscal and governance reforms, d) progress and performance on development and implementation of country's PRSP, and e) extent and nature of IWRM and WSS components in country-owned poverty reduction strategy papers.

To enable the facility to achieve its objectives, governments throughout Africa will need to meet their commitments with respect to proper budget

allocations for investment, maintenance, subsidies, proper management and regulation of the water sector, and paying their water bills. This should strengthen the willingness of donors to provide additional financial support for water priorities, particularly grant financing of peri-urban and rural investments, and make them amenable to persuasion to move away from unnecessary conditionalities.

The EU Water Initiative, and particularly the Africa component can use the AWF to channel funds for water projects in Africa.

D3.5.2 Tacis (Water Specific Component)

The Tacis programme is supporting a number of initiatives and programmes linked with the management of trans-boundary water bodies in the NIS, such as the Aral Sea, the Caspian Sea, the Black Sea or trans-boundary rivers. In addition, water management and supply is one of the priorities included in the Regional Cooperation Indicative Programme 2002-2003.

Aral Sea

Since 1995 Tacis has been supporting the Aral Sea Basin Programme together with UNDP/UNEP/WB (GEF project) through the Water Resources Management and Agricultural Production in Central Asian Republics (WARMAP) projects. An amount of €7.25 million was already committed. Main objectives were the preparation of interstate agreements on water management, creation of regional information systems (WARMIS), analysis of water use and farm management (WUFMAS) and assistance to the GEF project.

Further support amounting to €2.5 million will be provided through another WARMAP project included in the Regional Cooperation Action Programme 2000. Under the condition that the countries concerned will sign the relevant agreements prepared under previous Tacis assistance, this project will continue providing support to the Interstate Agreements, improved river basin management and dissemination of information. TOR are being finalised and it is expected that the project will start later this year.

Caspian Sea

Since 1997 Tacis has been supporting the Caspian Environmental Programme (CEP) together with UNDP/UNEP/WB (GEF project). Two projects of a total amount of €6.5 million have been completed (the later in December 2001). Tacis assistance has been instrumental for establishing the initial CEP framework and carrying out main part of the technical research necessary to developing the future Caspian Strategic Plans. The assistance included support to four Regional Thematic Centres located in the NIS, the identification of investment projects and support to the development of a draft sustainable fisheries management agreement.

Further support of €4 million has been included in the Regional Cooperation Indicative Programme 2002-2003. The main objective is the promotion of

sustainable development and management of natural resources in the Caspian Sea. More specific objectives are: to assist the four NIS in the region meet their commitments under the Caspian Environment Programme, especially with regard to the management of fish resources, pollution reduction and prevention and monitoring of environmental factors, including oil contamination, water level and the quality of the sea; to increase the level of investment related to the Caspian Environmental Programme, by assisting in the development of demonstration projects. A project should be included in the Action Programme 2002, but it will not start before mid-2003.

Black Sea

Since 1992 Tacis has been one of the main donors of the Black Sea Environment Programme (BSEP) together with UNDP/UNEP/WB (GEF Project). Several projects have been completed representing an amount of around €8 million.

Other projects should start in 2002:

- A €3 million technical assistance project (included in the Regional Cooperation Action Programme 2000) will support the three RAC-Regional Activity Centres in the NIS establishing regional credibility and financial sustainability, maintain and develop the impetus of the technical work programme and developing regional strategy documents, including monitoring, priority setting for pollution reduction, biodiversity recovery, improvement of the management of the coastal zone, information and data exchange; continue the successful information preparation, dissemination and public awareness activities of earlier Tacis support; and support specific activities of the BSEP secretariat to become a fully operational Secretariat;
- A €7.5 million Tacis co-financing of an EBRD investment project (included in the Regional Cooperation Action Programme 2001) aiming to improve the quality and reliability of the water supply as well as the waste water treatment for Kherson and Mariupol (South Ukraine). Tacis contribution will focus on environmental components of the EBRD project.

Moreover, further support of €3 million has been included in the Regional Cooperation Indicative Programme 2002-2003 aiming at developing an integrated approach for NIS countries around the Black Sea based as far as possible on the most important elements of the Water Framework Directive. A project should be identified and included in the Action Programme 2003, thus not starting before 2004.

Trans-boundary Rivers Management

A Joint River Management €4 million project, supported through the Regional Cooperation Action Programme 1999, aims at preventing, controlling and reducing adverse trans-boundary pollution impacts caused by the quality of four rivers: Kura (Georgia/Azerbaijan), Pripyat

(Belarus/Ukraine), Tobol (Russia/Kazakhstan) and Seversky Donez (Russia/Ukraine). It links with the UNECE Convention on the use and protection of trans-boundary watercourses and lakes and assist in the application of guidelines on water-quality monitoring as well as promoting investment into trans-boundary river monitoring. The project started in January 2001 and will be completed after 2 years.

Water management and supply

Water management and supply is one of the priorities included in the Regional Cooperation Indicative Programme 2002-2003. The general objective is to reduce pollution and health risks and provide water resources to the population while promoting a more efficient use of these resources. The specific objective is to strengthen the institutional capacity and regulatory compliance of water services operators (water supply, distribution and wastewater collection) as well as improving their financial, environmental and health performance. A total amount of €5 million has been foreseen for this activity to be included in the Action Programme 2003 under which concrete projects will be identified (start not before 2004).

The EU Water Initiative could collaborate with Tacis in support to the management of trans-boundary water bodies.

D3.5.3

The Nile Basin Initiative (NBI)

The Council of Ministers of Water Affairs of the Nile basin states launched the NBI in February 1999. It includes all Nile countries and provides an agreed basin-wide framework to fight poverty and promote socio-economic development in the region. The NBI has a strategic action plan, comprising basin-wide projects as well as sub-basin joint investment projects. One of seven shared vision programme projects focuses on water resources planning and management. In November 2002, the NBI and the Government of Uganda signed an agreement that gives the NBI legal status.

The Eastern Nile Subsidiary Action Programme (including Egypt, Ethiopia and Sudan) also includes a project on integrated water resources management. The countries of the Nile Equatorial Lakes Subsidiary Action Programme (including Burundi, DR of Congo, Egypt, Kenya, Rwanda, Sudan, Tanzania and Uganda) also include a multi-country project on water resources management within their strategic framework.

The NBI envisages a Nile Basin Trust Fund to provide a coordinated, cost-effective vehicle to administer donor support, with a committee providing fiduciary oversight. Nile basin countries will pay annual dues to the initiative.

Financing needs of the NBI are estimated in a May 2001 document (The Nile Basin Initiative – a strategic action programme) at an estimated US\$211 million (US\$122 million for the shared vision programme projects; US\$79 million for the subsidiary action programme projects; and US\$10 million for NBI facilitation and management).

Fourteen Development Agencies/IFIs expressed interest in the seven shared vision programme projects. These included Canada, Denmark, Finland, Germany, Italy/ FAO, IUCN, Netherlands, Norway, Sweden, UK, the UNDP, US and the World Bank. The core NBI donor/IFI Nile team consists of CIDA, UNDP, GTZ, SIDA and the World Bank.

In a press release dated 28 June 2001, these partners at an NBI meeting in Geneva expressed initial financial support of at least US\$140 million to finance the full programme, with a Trust Fund was to be established by the World Bank for this purpose.

The development of further financing sources and mechanisms for the NBI, and how these may complement the goals of the EU Water Initiative, together with how the Initiative may be able to work as a catalyst to trigger further NBI funding (especially from the private sector), are important issues to pursue.

The EU Water Initiative could scale up this innovative multi-donor facility, and expand to other river basins.

D3.5.4 Partners for Water and Sanitation

In March 2001, the British Prime Minister announced five initiatives to feed into the WSSD process, including one on water. Chief Executives of UK water companies, other private sector companies and NGOs offered their services to the Water Initiative, which became known as Partners for Water and Sanitation.

From the UK Government the lead was given to the Department for Environment, Food and Rural Affairs, although the Department for International Development, the Foreign and Commonwealth Office and the Department for Trade and Industry are also members. Private sector companies include most of the British water companies as well as a number of engineering companies. NGOs include Tearfund, WaterAid and the World Wildlife Fund. A trade union, Unison, is also represented in the Partnership.

The purpose of the Partnership is to demonstrate innovative and clearly-differentiated approaches to developing stakeholder capacity for the provision of sustainable access of poor communities to water and sanitation. The stated objectives of the initiative are to:

- Demonstrate effectiveness of multi-stakeholder engagement;
- Promote socially and environmentally sustainable services; endorsing principles of good water management;
- Promote an environment that attracts investment and ensures financial sustainability;
- Focus to be on secondary towns and peri-urban areas in Africa;

- Deliver tangible and sustainable benefits that make an acknowledged and verifiable difference at the local community level;
- Promote the strong inter-linkage between water supply and sanitation; and
- Promote best practice and develop guidelines for effective and sustainable tri-sector partnering.

The Initiative aims to work alongside existing water and sanitation programmes in partner countries and to match the skills and expertise of UK partners to areas of identified need. To date, contacts have been made with national and local government, NGOs and private sector companies operating in South Africa and Uganda.

The Partnership aims to complement existing initiatives such as PPIAF, to build on experience gained from undertakings such as BPD, and to link with initiatives such as the Cities Alliance and Water for African Cities.

The EU Water Initiative could partner with and potentially scale up this initiative to promote innovation and sound commercial principles in the water sector, and to link with local leaders in Africa to determine where partnerships are of most use.

D3.5.5

Netherlands multilateral programmes

In recent years Dutch Development Co-operation has started channelling funds through partnership programmes with multilateral organisations. This is commonly known as the “Dutch Window”. Such partnerships mainly consist of programme financing as part of a multi-donor effort, and may include core funding as well. To date partnerships for water management (including water and sanitation) are in place with a number of multi-lateral organisations, including the World Bank (and through it, with the WUP or the Nile Basin Initiative) and regional development banks, including the African Development Bank or the Asian Development Bank. The total commitment of partnerships with multilateral or other international organisations amounts to about 120 million Euros for the next 3-5 years.

The partnerships mentioned above could be scaled up by involvement of EU (and/or member states) via the Water Initiative. These are open-ended partnerships, open for other parties and with flexible funding. The Netherlands would welcome other parties (EU, member states, other donors, NGO's, private sector) to join in on these partnerships.

Annex E

Guidelines for good water
Governance providing
access to safe drinking
water and sanitation

Water is a primary human need and water supply and sanitation are basic social services. The United Nations Committee on Economic, Cultural and Social Rights agreed on a "General Comment" on water as a human right in November 2002.¹

The General Assembly of the United Nations has set the objective "To halve, by the year 2015, the proportion of people who are unable to reach or to afford safe drinking water" (Millennium Declaration). Access to drinking water and access to sanitation are inextricably linked; the Johannesburg Plan of Implementation thus extended this objective to basic sanitation and also stated the need to develop integrated water resource management and water efficiency plans by 2005.

The combined commitments of the many stakeholders in the provision of water supply and sanitation services are keys to fulfilling the challenge of the Millennium Goals for water. The aim of this statement is to contribute to a better understanding of respective roles, and therefore to more efficient actions on the ground. It has been prepared within the framework of the Water Initiative of the European Union (EUWI), by the Finance Working Group, with the participation of a broad stakeholder group. It consists in a set of basic principles that are proposed to the actors of water supply and sanitation worldwide; they are an analytical tool proposed by the Finance Working Group, which needs to be adapted to the specific context of each country. This text can be freely adopted by partners, who aspire to establish good governance and improved management in the sector, thus allowing increased confidence and the adequate provision of services, especially for the poor.

E1.1

PRINCIPLES

The principles are based on the European Commission communication and Council's resolution 9696/02 on Water Management in Developing Countries. In particular, the EUWI emphasises the importance of the following in the provision of water and sanitation, with reference to the resolution and communication:

- **Safeguarding Water Resources:** The necessity of Integrated Water Resource Management, including ecosystems protection, is fully acknowledged; the fact that water resources cannot be appropriated by private interest is asserted.

(1) *"Water is fundamental for life and health. The human right to water is indispensable for leading a healthy life in human dignity. It is a pre-requisite to the realisation of all other human rights."* United Nations Committee on Economic, Cultural and Social Rights, 27 November 2002.

- **Right to water and Sanitation**²: States Parties have a duty to ensure that the vital needs of the entire population are met effectively
- **Community Public Services**: “Water supply and sanitation are basic social services”; “Pricing of water services should ensure financial sustainability”³.
- **Participation and Transparency**: “to apply a real integrated approach in which all actors cooperate as partners and transparent information is available to all stakeholders”⁴
- **Ethical compliance**: “to improve water governance and combat corruption”⁵.⁶
- **Equity and Solidarity**: to “ensure sustainable and equitable access to safe water [...] and to sanitation, with special attention to the basic needs of the poor.”⁷

E1.2 ROLES AND CONTRIBUTIONS

Although the primary responsibility for providing access to water and sanitation services rests with local and national public authorities, it is essential to involve a broader range of stakeholders.

The roles and contributions of stakeholders recommended in this statement are consistent with Resolution 8951/02 and are as follows:

E1.3 ROLE OF PUBLIC AUTHORITIES

The development of drinking water and sanitation services and the development of integrated water resource management plans require strong central and local public authorities. These should be constituted in accordance with the legislative framework in place in each country. Their role is to define and implement the general institutional framework, comprising:

(2)² Guiding principle no. 6, Annex to Communication 132.

(3)³ Paragraph 2 and 7 of the Resolution ; Guiding Principles no’s 9 and 10, Annex to Communication 132.

(4)⁴ Paragraph 7 of the Resolution ; Guiding principles no’s 2, 3, 5 and 7, Annex to Communication.

(5)⁵ See “Principles for managing ethics in the public service”, OECD Recommendation of the 23rd of April 1998, PUMA Policy Brief No 4 ?

(6)⁶ Paragraph 7 of the Resolution and Guiding Principle no. 1 Annex to Communication

(7)⁷ Paragraph 3 of the Resolution ; Section 4.2 – Management by Demand, Communication 132 ; Guiding Principle no. 6 Annex to Communication.

- Organisation of the policy , planning and regulatory framework to set up the goals, define the institutional framework and ensure compliance with the obligations of a public service.
 - Establishment, at the appropriate level, of authorities responsible for local services, taking into consideration the cost of water infrastructure and the need for local management in response to users' needs.
- a. The role of Public Authorities responsible for policy, planning and regulatory functions includes:
- Planning and deployment of efforts to achieve an appropriate national target, guided by the MDGs on water and sanitation.
 - Defining the framework for the integrated management of water resources which allows equitable allocation across all demands in a sustainable manner.
 - Enacting legislation and/or regulations to safeguard and sustain water resources and ecosystems and provide a stable legal and accounting framework
 - Implementing mechanisms for consultation, performance evaluation and reporting
 - Promoting the common public interest
- b. The role of Public Authorities responsible for organising service delivery implies the translation of central policy at local level, including:
- Definition of the limits between essential services and additional non-essential services.
 - Duty to implement the right of access to essential services in drinking water and sanitation for all,
 - Implementation of a sustainable pricing structure that is compatible with the economic means of the population and promotes responsible use of water resources.
 - Choice of the most appropriate management structure from the range available.
 - Reporting on water and sanitation services and ensuring effective control, including the transparency of pricing, water quality, development plans and, where appropriate, of tasks entrusted to water operators
 - Guarantee of users' and operators' rights by drafting and enforcing service regulations or other similar procedures.

E1.4

CONTRIBUTION OF CIVIL SOCIETY

The users, employees and non-profit service providers and associations have a key role to play in expressing the needs, and monitoring the services. The representatives of these stakeholders:

- play an active role in protecting the common public interest.
- contribute to protecting the environment, social and cultural values
- contribute actively to the exchange of information and a meaningful participation of users.

E1.5

CONTRIBUTION OF WATER OPERATORS AND OTHER SERVICE PROVIDERS

The role of public or private operators is based upon:

- Recognition of the pre-eminence of the organising authorities.
- Deploying in a professional manner the means and resources necessary to achieve the objectives set by the organising authorities
- Ensuring the continuity of service as defined in their contracts
- Managing assets within a long-term perspective having regard to the sustainability of the services
- Working and developing fair partnerships with local industrial partners and suppliers, and working with the representative trade unions

E1.6

CONTRIBUTION OF FINANCIAL INSTITUTIONS

Financial Institutions provide support to:

- Mobilising resources to ensure access for all, especially the poor, to drinking water and sanitation in the developing world.
- Working towards a long-term perspective, giving precedence to projects which ensure sustainability of access for all, enhancing the efficiency of development assistance and consolidating local organising authority's expertise.
- Contributing to the definition and implementation of adequate institutional frameworks guaranteeing financial sustainability

Annex F

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Annex G

List of Working Group Members and Acknowledgements

Acknowledgements

ERM Team Members would like to extend their most grateful thanks to DFID and to all members of the Working Group for the EU Water Initiative Finance Component.

The Working Group (WG) met three times: in January, March, and May 2003, to generate discussion and ideas on specific issues. The first WG was focused on discussing the overall issues involved in financing water and sanitation projects and on designing the framework for this analysis. The second WG presented preliminary results of the analysis for Sub-Saharan Africa, and the third WG worked on the development of more general practical guidance for the other regional components. The first two working groups were held in DFID premises, whereas the third working group was held at the EBRD. We are very grateful to both institutions for their great hospitality.

The WG comprised a range of stakeholders from various realms of expertise, including banks, NGOs, finance institutions, and government representatives, and the list is provided below. Working group members made an active contribution to the development of this Paper, through participation to the meetings, the provision of detailed comments in writing and contributing specific data. Special thanks extend to Julia Benn at the OECD who was very active in providing data from the OECD/DAC database and guidance on how to make best use of this data.

Type	Name	Organisation	Phone Number	Email
Core Working Group Participants				
<i>European Commission</i>				
	Friedrich Barth	EC DG ENV	(+32-2) 2990 331	Friedrich.Barth@cec.eu.int
	André Liebaert	EC DG DEV	(+32-2) 2992753	Andre.Liebaert@cec.eu.int
	Massimiliano Dragoni			Massimiliano.Dragon@cec.eu.int
	Pedro Henriques	EC	32 2 296 1714	pedro.henriques@cec.eu.int
<i>Member States</i>				
United Kingdom	Martin Walshe	DFID		m-walshe@dfid.gov.uk
United Kingdom	Hilary Grimes	DFID		H-Grimes@dfid.gov.uk
Denmark	Mogens Bregnbæk	Ministry of Foreign Affairs	45 33 92 00	mbregnb@um.dk
France	Francois Casal	Ministry of Environment		Francois.CASAL@environnement.gouv.fr
France	Alain Henry	Agence Française de Développement		henrya@afd.fr
Germany	Annette Van Edig	BMZ		VanEdig@bmz.bund.de
Netherlands	Bert Diphooorn	Min of Foreign Affairs - Water Support Unit	31 70 34 84 518	aj.diphooorn@minbuza.nl
<i>Others</i>				
IFI	Julia Benn	OECD - DAC	33 1 45 24 90 39	julia.benn@oecd.org
IFI	Jose Frade	European Investment Bank	352 43 79 27 27	j.frade@eib.org
IFI	Rod Matthews	DfID/PPC	0207 023 0552	rh-matthews@dfid.gov.uk
Camdessus Panel	James Winpenny	Secretariat of Camdessus Panel	352 34 18 87	winpenny@pt.lu
Private Sector	Jack Moss	Ondeo Paris	33 1 58 18 53 90	jack.moss@ondeo.com
Private Sector	Jacques Labre	Suez Group		Jacques.LABRE@suez-env.com
Private Sector	Tony Clamp	Thames Water		Tony.Clamp@thameswater.co.uk
Private Sector	Linda Kemeny	Thames Water	0118 373 89 50	Linda.Kemeny@thameswater.co.uk

Type	Name	Organisation	Phone Number	Email
Private Sector	Alan Hall	HR Wallingford		a.hall@hrwallingford.co.uk patrick.crawford@standardbank.com
Finance Sector	Patrick Crawford	Emerging Africa Infrastructure Fund	44 207 815 2780	patrick.crawford@standardbank.com
Finance Sector	Guy Leclerc	Price WaterHouse Coopers - Paris	33 1 56 57 82 30	guy.leclerc@fr.pwcglobal.com
NGO	David Boys	Public Service International	33 4 50 40 11 65	david.boys@world-psi.org
NGO	Stephen Turner	Water Aid	020 7793 4512	stephenturner@wateraid.org.uk
NGO	Belinda Calaguas	Water Aid		BelindaCalaguas@wateraid.org.uk
NGO	Ken Caplan	Building Partnerships for Development	020 77934557	Kencaplan@wateraid.org.uk
ERM Team				
	Dominic Waughray	ERM London	44 207 465 7380	dominic.waughray@erm.com
	Sophie Tremolet	ERM London	44 207 465 7389	sophie.tremolet@erm.com
	Rachel Cardone	ERM Washington DC	01 202 466 90 90	rachel.cardone@erm.com
	Courtenay Cabot	ERM London	44 207 465 7664	courtenay.cabot@erm.com
	Sara Browning	ERM London	44 207 465 7237	sara.browning@erm.com
Associated / Consulted Members				
United Kingdom	John Hodges	DfID		j-hodges@dfid.gov.uk
United Kingdom	John Ballard	Defra	0207 944 5350	john.ballard@defra.gsi.gov.uk
United Kingdom	Fiona Rushton	Defra	020 7944 5385	Fiona.Rushton@defra.gsi.gov.uk
United Kingdom	Anna Bramwell	Tacis	322 295 6367	Anna.Bramwell@cec.eu.int
Mediterranean comp.	Vangelis Constantianos	GWP Med	30210 3247490	secretariat@gwpmed.org
Africa comp.	Dennis Mwanza	Water Utility Partnership	225 21 24 08 28	ddmwanza@wupafrica.org
Africa comp.	Albert Wright	Africa Water Facility	1 703 644 7458	amwright2@msn.com
EECCA comp.	Jens Kristian Lorup	EECCA Consultant		jkl@dhi.dk
EECCA comp.	Camilla Trolle	DANCEE	45 32 66 02 42	cht@mst.dk
	Palle Lindgaard-			
EECCA comp.	Jorgensen	DANCEE	45 32 66 01 00	plj@mst.dk
EECCA comp.	Ulla Blatt Bendtsen	DANCEE	45 32 66 01 00	ube@mst.dk
EECCA comp.	Brendan Gillespie	OECD	33 1 45 24 93 02	brendan.gillespie@oecd.org

ERM's LondonOffice

8 Cavendish Square
London
W1G 0ER
Tel +44 (0) 20 74657200
Fax + 44 (0) 20 74657350