Theme 5 Report
Finance

Theme Coordinator:

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Although, the water sector is the nexus of the food, energy, environmental and poverty crises facing the world, it remains woefully under-funded. The financial needs of the sector as a whole are enormous. In water supply and sanitation alone, considerable amounts are needed in developing countries to provide access to fast growing populations and rehabilitate deteriorating infrastructure – while in the developed world, huge investments are needed for modernizing and upgrading infrastructure to rise environmental standards. The recent food crisis is now providing a major impetus for stepping up investment in water for agriculture. The energy challenge and climate change mitigation agenda demand that investments in hydropower be again considered a viable option. In spite of recent years efforts to increase the amount of financing for the water sector, the gap between needs and actual investments is actually widening.

Topic 1: Achieving Sustainable Financing of the Water Sector

Improving the understanding of the impact of the water sector in poverty reduction and economic development. The water sector is fundamental to the poverty reduction and economic development agendas; yet it only manages to attract a fraction of the financing that is needed. Improving decision makers' and political leaders' understanding of the economic, social, health, and environmental benefits of investing in water is an important element for encouraging the flow of sustainable financing.

Sustainable financing for the water sector is also about governance and sector reform. Poor governance and a lack of sector reform have constrained the ability of the sector to attract stable funding. Any increases in financing cannot be effective unless made in the context of reforms that tackle some of the fundamental problems. Simply issuing another call for "more money" will not help.

Water sector reforms must address both the demand and supply side. The 2006 Gurria Report issued after the 4th WWF stated that the significant financing requirements of the water sector can only be satisfied if, in addition to measures to increase the supply of finance, measures to improve or "un-lock" the demand were undertaken. Helping to bridge the gap between the supply and demand side is very much in line with the overall theme of the 5th WWF - "Bridging Divides". More focus is needed on sector risk management through improving the operational environment and efficiency of the sector and minimizing investment costs. Furthermore, the overall flow of financial resources, revenues (tariff policy) and lending/transfers, not only needs to be increased, but also used more effectively by putting in place sustainable financial policies.

Improving the enabling environment and efficiency of service providers is a priority. Lack of a viable policy and regulatory framework and poor operational performance of service providers directly affects financing for sector. Improving operational efficiency by maximizing cost recovery levels and tariff collection, minimizing water losses and ensuring competent management can increase the ability of a service provider to generate and maintain the cash flow necessary for investments in service quality and increased coverage. This can not be achieved through just capacity building and investing in "soft" activities such as training, twining and technical assistance - even though these are undoubtedly important. Governments need to be ready to challenge the status quo and push for reforms of the service providers, addressing governance issues, improving accountability and incentives, and reducing political interference.

There needs to be a greater focus on minimizing the "cost" side of "cost-recovery through better investment projects. As water is an asset-intensive sector, requiring large investments in infrastructure, poor investment decisions and careless design can potentially do more harm than can be remedied through tariff increases or good operational or financial management. Much needs to be done to improve the efficiency of investments – thereby providing more "bang for the buck" without even increasing current investment flows. Greater realism in investment planning and execution is called for, so as to choose the most convenient cost option appropriate for the needs of the targeted population, the country's affordability level and the consumer's willingness to pay. It is also becoming more and more important to adopt an integrated approach to urban water management – considering the multiple interactions between water, sanitation, drainage, land use and solid waste to maximize the benefits of investments.

Pooling grants with loans to minimize the affordability constraints and bring down sector risk. In many developing countries, large parts of the population cannot afford the level of tariffs required by full cost recovery, thereby limiting the achievement of the water and sanitation targets of the MDGs. A potential short-term solution is resorting to grant or subsidies coupled with long-term loans to minimize the affordability constraint. Scale up projects in support of pro-poor agendas can enable a relatively scarce source to be used more effectively and efficiently.

Sustainable financing requires making difficult trade-offs. Ultimately, financing for the water sector can come only from three basic sources: tariffs, taxes and transfers ("the 3 Ts"). Achieving financial sustainability requires securing sufficient combined cash flows from these sources to attract long-term financing. Unfortunately, finding the right mix between the 3 Ts is a difficult process. A balance must be found among economic, social and environmental objectives, involving trade-offs that can be politically difficult to reach. This is compounded by the fact that, in the water sector, responsibilities are shared across various ministries and involve regional and local authorities. Setting unrealistic targets, without clearly identified resources to fund them, has been unfortunately a common practice that has exacerbated the problems of securing viable financing. Each country needs to carefully determine what can be realistically financed and from which source. Too many governments have shied away from explicitly addressing these trade-offs, leaving the water sector chronically under funded.

Strategic Financial Planning as a tool to foster consensus on sustainable financing. The experience in many countries shows that finding the right financial framework for the water sector – i.e. the proper balance between the 3 Ts - can be a lengthy process. There is no "one size fits all" solution. The most successful experiences are those where a broad consensus was achieved among stakeholders over how to share the costs. The Strategic Financial Planning (SFP) approach offers a participatory framework that can be very useful in promoting dialogue and consensus on hard policy choices. By providing a transparent framework for analyzing the financial trade-offs surrounding water, it allows stakeholders to build common understanding and help inform difficult choices. Processes do matter, and SFP can be a major tool to remove barriers to progress.

Diversifying the sources of finance to bridge the gap in financing. Given the huge capital expenditure requirements of the water sector, no single source of finance is large enough to meet the financing needs in the short to medium term. In addition to optimizing the financing from the 3 Ts, debt and equity financing, both from international financing institutions and from domestic financial and capital markets, is key for bridging the financing gap for capital investments. However, access to such sources of finance is constrained by prevailing sector risks. Achieving a stable and robust cash-flow based on tariff revenues, as well as maintaining an efficient operating environment, are essential for a water services provider to achieve creditworthiness.

Topic 2: Pricing Strategies as a Tool for a Sustainable Water Sector

That "someone has to pay" for infrastructure must be recognized. The need to combine financial viability and affordability of services has often led to polarized debates. It is true that the water falling from the sky is free, but this is not the same water we use in our everyday lives. The infrastructure needed to store, transport and deliver it to users is costly and needs to be paid for, and the same is true for workers and suppliers of water utilities. These costs can ultimately be covered either through tariffs, taxpayers' money or transfers (ODA, philanthropy, etc.). While various mixes are possible, the experience shows that keeping average tariff *levels* low (i.e. well below costs) promotes water wastage and contributes to the vicious circle of underinvestment, deteriorating assets, poor service and lack of access, from which the poor suffer the most. In fact, several studies in the developing world have shown that the unconnected poor families end up paying the most for drinkable water.

That water is a valuable and vulnerable resource also needs to be recognized. The Dublin principles for Integrated Water Resources Management IWRM) clearly recognizes that water is both a social and economic good, whose value should be recognized by all users. Ignoring the economic dimensions of this essential resource leads to a lack of recognition of the value of water and its excessive exploitation or inefficient allocation, with negative consequences on the capacity of the natural resource base to continue providing environmental functions for future generations. This important aspect will not be specifically discussed under the program of sessions in Theme 5, but needs to be highlighted.

The move towards sustainable cost recovery must be achieved in parallel with social viability. Requiring users to pay for services is essential to ensure financial viability of service providers, and to ensure demand management (avoiding water wastage). In most developing countries, a significant proportion of the population can not afford the full cost of service and vulnerable groups exist in developed countries as well. The goal of cost recovery should not be achieved at the expense of social concerns, and support mechanisms need to be put in place to keep services affordable for all. This can be achieved through the design of appropriate tariff *structures* where cross-subsidization takes place between different classes of users, or by other direct subsidies provision (such as ODA or tax transfers) to cover the tariff gap. Care should be taken that subsidies are well targeted –to avoid past mistakes where middle-class users were subsidized while the poor were excluded from services. To this end, subsidizing connections may be a better solution. Direct income support mechanisms can also be implemented, although this may require more upfront investments in well identifying the targeted customers. Tariff increases are not the only way to improve financial resources, especially for sanitation and irrigation, which have more of a public good aspect. In most OECD countries, the cost of investing in wastewater treatment infrastructure has been largely financed through tax transfers from the national budgets, rather than from customers tariffs.

Accountability and effective economic regulation is essential for sustainable tariffs and their acceptability. Moving tariffs towards cost recovery levels requires more customer effort. Tariffs cannot be developed in isolation, and service quality needs to be improved commensurably to justify the increase. Efficiency of service provision is necessary to minimize investment and operating costs, reduce physical losses and non-revenue water - including the improvement of collection rates. Improving the efficiency of water services providers shall reduce the need for tariff increases, while at the same time increasing their acceptability. An effective economic regulatory framework needs to be developed to ensure that costs are reasonable, that service providers and investment agencies are efficiently run, and all actors are accountable for results. To this end, sufficient information on costs and other performance indicators needs to be available, the regulator's institutional capacity needs to be adequate and a transparent processes needs to be established.

Topic 3: Pro-Poor Financing Policies and Strategies

Overcoming obstacles to serving the urban poor. To meet the MDGs for water supply and sanitation, project planners and service providers in developing countries will have to overcome a number of barriers that impede the improvement of services for the urban poor. These challenges are enormous, particularly in the context of rapid population growth and changing socio-economic composition. It is also widely recognized that focusing more attention on improving services for the poor in towns and small cities is essential to prevent massive migration to the large cities. Key impediments to success are often rooted in government slum, housing and land policies. Reforming these laws and policies is essential for any long-term success. However, changing policy requires proof of how changes will help and buy-in from all stakeholders. While each city and region faces unique challenges, there are common lessons to be learnt that apply across borders.

The need to promote targeted subsidies. While low tariffs have often been advocated as a way to ensure affordable access for the poor, there is increasing evidence that they do not in reality benefit the poor – instead, they promote wastage of water, reduce the resources available for investment, and in developing countries mostly benefit richer households who have access to the networks. Because in many countries a large proportion of the population can not afford the full cost of services, subsidies are needed, but they need to be properly targeted. Output-Based Aid (OBA) approaches are one of the viable options to ensure that the resources used to subsidize the poor truly reach the intended beneficiaries.

Promoting the voice of the poor and the unserved. The needs of the poor are often badly understood, their voice is rarely heard. Their specificities, especially in terms of the type of services they desire and can afford, have to be better taken into consideration. Services providers must become more flexible in the range of service options they provide. Their specific financing needs, through the promotion of micro-finance initiatives, needs also to be given more consideration. Finally, it is important to analyze why the current status quo is unfavorable for the poor, to remove the disincentives to serve them, and address vested interests issues.