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Addressing the financing gap in the water sector in Ethiopia, Rwanda and Uganda

Catarina Fonseca and José Frade

Many countries have a massive finance gap in meeting the ambitious targets they have set for the water sector (UN-Water, 2019). This means increasing one or more sources of funds: tariffs, taxes and transfers. Each country has its own specific opportunities and bottlenecks in increasing one or more of these sources. In 2018, IRC commissioned three country assessments (desk review and in-country interviews) to identify the main constraints to attracting additional finance to the sector in three countries: Uganda, Rwanda and Ethiopia. This briefing note synthesises the findings, highlighting commonalities and differences between the three countries.

The assessments focused on:

- an analysis of the sector: policies, strategies and plans, institutional and organisational/service provision framework and current status;
- an analysis of the investment needs and financial resources available: demand and supply of financial resources (the 3Ts – taxes, transfers and tariffs), management of the flow of the resources, absorption capacity and funding gap and main constraints/bottlenecks;
- ways to address the main issues and remove the financial and non-financial constraints.

Each of the assessments provides concrete practical recommendations on overcoming the institutional and organisational constraints to attracting more public and private finance to the water sector.

FRAMEWORK USED FOR ANALYSIS

The water sector in Ethiopia, Uganda and Rwanda has seen very positive progress in the past 10 years (UNICEF-WHO, 2019). Recent reforms in each of the countries and political commitment to the water sector have improved coverage and governance indicators. However, given the high ambitions for the sector, all the countries require additional finance. Both public and private finance are available for all the countries to different degrees, but are difficult to mobilise for the sector.

The assessments primarily concern the water sector in rural areas and small towns. They focus on areas of increasing urbanisation that are served by a mix of community managed services, small water enterprises, and rural and urban utilities (Figure 1).

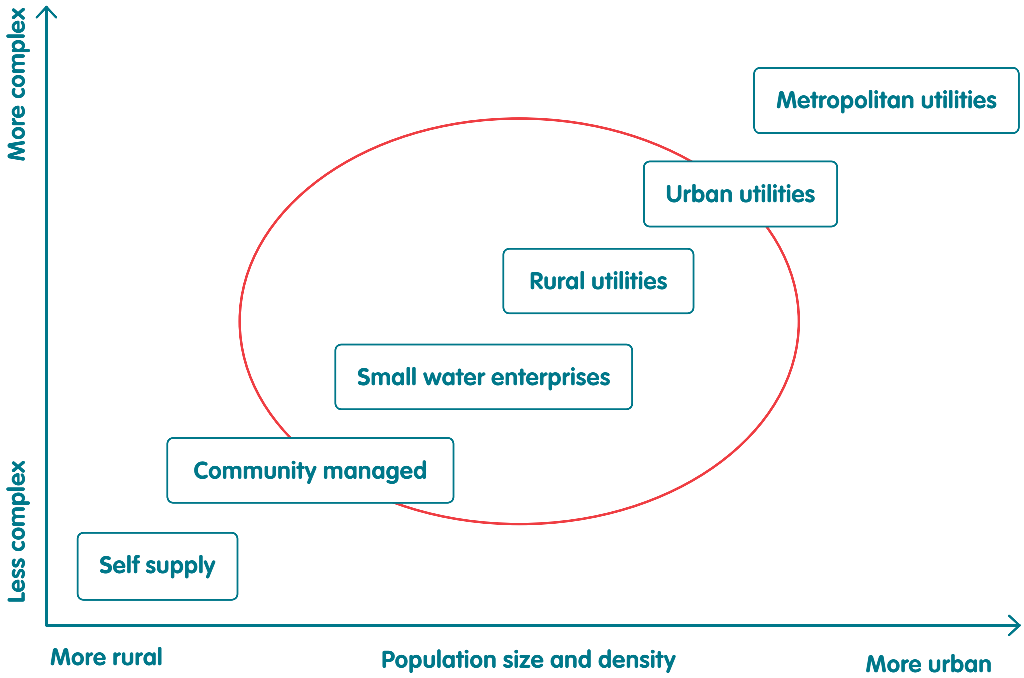

FIGURE 1 FOCUS OF THE COUNTRY FINANCIAL ASSESSMENTS (IN RED)

The assessments were analysed using the 3Ts and the framework developed by IRC, water.org and World Bank (Pories et al., 2019). Ten foundational issues, listed below, were assessed in each of the countries.

Sectoral access to finance

1. The need for financing strategies and a system for maximising funds to achieve social objectives.
2. More effective tariff-setting practices and economic regulation.
3. The need for adequate regulation and accountability mechanisms.
4. Clarity of mandate and performance obligations of service providers.

Service providers' access to finance

5. The need for solid financial and operational management.
6. Capacity strengthening for business planning and client acquisition.
7. Autonomy and a legal framework.

Suppliers of finance

8. Addressing the mismatch between commercial bank risk profiles and sector realities.
9. Avoiding market distortions.
10. Preventing development funds from 'crowding out' private investment.

A systems approach was used to analyse the assessments. This assumes that addressing only one or two bottlenecks or foundational issues will not be enough to see the required changes in the sector. The findings provide options that can be discussed by country stakeholders to prioritise and develop concrete interventions to attract and mobilise additional financial resources to the sector.

FINDINGS FROM COUNTRY ASSESSMENTS

The analysis of the demand and supply of finance in Ethiopia, Uganda and Rwanda clearly shows large funding gaps to reaching the SDGs and other national targets set by the respective governments. But each of the countries also has concrete opportunities to unlock additional finance.

The analysis of the three main sources of finance, the 3Ts, shows that the three countries have strong limitations in raising more taxes internally given the reduced fiscal space, limited tax collection and other public financial management constraints (UNICEF, 2019).

Moreover, the national budget allocations confirm that strong competition among several sectors is a limiting factor in mobilising more taxes in the short to medium term. Regarding the transfers, foreign governments' priorities for international aid (Overseas Development Assistance – ODA) are also changing and once countries move from low towards middle-income country status, the ODA will adopt a pronounced downward trend.

The only financial source that is not limited by fiscal constraints and competition with other public sectors is the water tariffs. However, these are limited by affordability or low willingness to pay associated with poor service quality. The main objectives of the cost recovery policies defined in the countries seem sound but were not achieved due to the low level of tariffs overall and the application of subsidies that don't necessarily benefit the poor.

Overall, the conditions for private investment have not yet been created in the three countries. Blended finance is incipient or non-existent. Public finance, development grants and concessional loans are largely dedicated to funding investment in new infrastructure rather than towards rehabilitation and renewal. As such they are not being used to leverage private capital flows, for example by softening lending conditions, providing guarantees, or as technical assistance to support capacity building and increased creditworthiness of borrowers/utilities.

Using the framework for analysis of foundational issues (Figure 2, below), we can draw the following conclusions from the assessments.

- There is a strong need in the three countries for **financing strategies** and systems that ensure that public finance and grants are directed towards achieving social objectives. The financing strategies should be the foundation from which to attract and mobilise a significant amount of additional resources to cover the funding gap in larger urban utilities while freeing up taxes and transfers to prioritise services to populations with lower income populations.
- The foundation on which **tariff-setting practices and economic regulation** is based is weak in the three countries. In view of affordability constraints, there is an interest in promoting cross-subsidising tariffs at regional level to ensure cost recovery and reduce the wide range of unit service costs between urban areas with high population densities and rural areas with low population densities, and between abundant water resources and scarce water resources. This can be achieved by clustering and merging utilities serving smaller or peri-urban areas and rural areas.
- All three countries are aware of the need for adequate regulation and accountability mechanisms. Many of these are already available in Rwanda, in preparation in Uganda and under discussion in Ethiopia.
- The most critical aspect across the three countries concerns the **framework for effective service provision,** namely the high number of dispersed service providers who are unable to reach economies of scale and therefore need a degree of clustering and merging. Uganda took an important step towards that goal by creating six regional water authorities. Rwanda is working towards larger private operators, and Ethiopia is still lagging behind with a large number of weak utilities and service providers.
- Related to the previous point is the need for the **more efficient financial and operational management** of service providers. There is significant progress to be made in Ethiopia and Rwanda and it will not be achievable in the short or medium term. In Uganda, the existing revolving funds are being used by each of the authorities serving small urban centres and rural areas to improve services and operations. This system is expected to deliver significant progress at regional level.
- Each of the countries has granted autonomy to service providers and has the appropriate legal framework. However, changes will be required to pursue the further clustering and merging of service provision suggested above.
- In terms of finance supply, **lending to the water sector is perceived to be high risk.** As such, commercial banks do not make the finance required readily available and when they do so, the loans are very costly and have short repayment periods. In the medium term, the risk profile of the sector in the three countries may decrease if mobilising more financial resources from tariff revenues allow cost recovery good practices and availability of guarantees.
- Preventing development funds from 'crowding out' private investment and avoiding market distortions is not relevant at this stage, nor in the short term, in the three countries. **The conditions for private investment have not yet been created.** The large funding gap still makes concessional loans from international financing agencies relevant and necessary. Currently, the critical aspect is the paying back of the development funds (debt service) in the three countries by taxes with limited or no contribution from tariffs.

Figure 2 summarises the findings from the assessments in a traffic light system, indicating the areas that need further support and strengthening. The areas for priority intervention () are proposed and detailed in the country summaries. These areas have been prioritised because they underpin the remaining foundational issues and have the potential to unlock and mobilise some of the financing needed.

Foundational elements to attract additional finance	Ethiopia	Uganda	Rwanda
Financing strategies and policy			∴
Tariff setting and economic regulation		∴	∴
Regulation and accountability mechanisms			
Clarity of mandate and obligations of service providers	∴	∴	
Service providers financial and operational management	∴	∴	∴
Business planning and client acquisition			
Autonomy and legal framework			
Commercial bank risk profile			
Market distortions		Not applicable	
Development funds crowding out private investments		Not applicable	

FIGURE 2 RESULT OF THE COUNTRY ASSESSMENTS USING THE 10 FOUNDATIONAL ELEMENTS AND AREAS FOR PRIORITY INTERVENTION.

RECOMMENDATIONS

There are strong limitations to taxes and transfers to increase the financial resources available to the WASH sector in Ethiopia, Rwanda and Uganda. As such, the option that remains is to maximise the role of tariffs in attracting more resources and combine it with the leveraging role of both taxes and transfers.

Taxes and transfers in the form of grants could be used for several important and well-known objectives, namely to:

- launch new financial instruments (Rwanda) or strengthen existing mechanisms such as the revolving funds (Uganda, Ethiopia);
- prioritise investment on infrastructure for the unserved and lower income population (all countries);
- strengthen the enabling environment by continuing to provide capacity building where still necessary to improve the efficiency and creditworthiness of utilities;
- establish effective tariff and cost recovery policies that minimise affordability constraints such as regional cross-subsidisation within the service area by clustering or merging the service providers. This started to be applied in Uganda, progressing in Rwanda and non existent in Ethiopia.
- strengthen regulatory functions in all countries to make service provision and accountability transparent.

REFERENCES

The three detailed country assessments and the sources of information are accessible on the IRC website.

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Edited by Joanna Bouma
Layout by Punt Grafisch Ontwerp
Proofread by Vera van der Grift

Visiting address
Bezuidenhoutseweg 2
2594 AV The Hague
The Netherlands

Postal address
P.O. Box 82327
2508 EH The Hague
The Netherlands

T +31 70 304 4000
info@ircwash.org
www.ircwash.org