OBApproaches

March 2005 | Note Number 004

Output-based aid in the Philippines

Harnessing political will to provide water services to the poor

By Chiaki Yamamoto and Catherine Hunt *

The Philippines has been unable to meet its growing demand for adequate water services. Indeed, the share of the population with access to water has fallen, particularly among the poor, as a result of frequent political turnover, fragmented regulatory oversight, and lack of coordination among service providers. Many communities have struggled with governance issues caused by overlapping responsibilities among local, provincial, and national authorities for planning, financing, tariff setting, and sector oversight. Communities also have been unable to raise funds for the new connections needed to meet the rising consumer demand.

One province, thanks to the political will of its governor, is exploring how best to respond to the issues of governance and unmet demand. After first dissolving the local Water District, the province is introducing an output-based aid approach to water supply under a concession contract. The private operator will be paid on the basis of performance, receiving a payment from the government for each connection made to a household preidentified as poor.

Although some 80 percent of Filipinos have access to safe drinking water, many of those who do must rely on self-provision: less than half the population has access to piped water supply through a household connection. In rural areas only about 20 percent have access to formal water supply services. The inadequate water services—with both poor quality and faulty delivery—give rise to public health concerns as well as economic losses for key industries.

Local government units—provinces, cities, municipalities, and barangays (districts)—are legally responsible for providing water and sanitation services to their constituencies. They can provide the services directly, contract with a private provider or community-based organization, or create independent Water Districts with supervision from the Local Water Utilities Administration (LWUA), a nonbank government financial institution. In practice, various local providers coexist, operating under different regulatory and financial systems. As a result, individual providers lack clear accountability for expanding water and sanitation services.

Investment in the sector has been around $55–73 million a year, with much of this going to Metro Manila.[1] This level is far below what is needed to achieve the Millennium Development Goal of reaching 90 percent of the population with formal water supply services by 2010. A series of laws enacted in the 1990s were aimed at stimulating private participation in infrastructure, including water and sanitation. But the private sector has shown little appetite for investment in recent years. Contractual disagreements in transport sectors—notably the cancellation of an airport project and delayed rail and road projects—as well as bankruptcy of metro Manila water concessions have led private investors to take a cautious stance toward new infrastructure projects.

A new approach to water provision in La Union

Facing poor quality and limited coverage of water supply services, the province of La Union—at the initiative of its governor—is introducing an output-based aid (OBA) approach in the sector. Comprising the provin-

Chiaki Yamamoto* is a private sector development specialist, and **Catherine Hunt a junior professional associate, in the Infrastructure Economics and Finance Department.

*Special thanks to **Luiz Tavares**, World Bank task team leader of the Philippines Second Local Government Unit Urban Water and Sanitation Project. This note also benefited from comments by **Dirk Sommer**, senior infrastructure specialist in the Infrastructure Economics and Finance Department.*

[1] *The note uses the exchange rate US$1 = ₱55.*

cial capital (San Fernando) and another 16 municipalities, La Union ranked 17th in per capita income among the country's 79 provinces in 1997, and 11th in the Human Development Index. Urban water supply was until recently provided by the Metro La Union Water District, whose service area covered the capital and four other municipalities (Bacnotan, Bauang, San Gabriel, and San Juan). Of the approximately 52,000 households in this area, only 15 percent are connected to the water supply. Service is far from efficient: about 40 percent of the water produced is lost through leakage.

An OBA approach was seen as having important advantages over other options for service provision. One is the ability to target the poor. The proposed project combines service provision by a private operator with a subsidy payment for each connection made to a preidentified low-income household. While the concession contract has yet to be signed, its design reveals a unique approach to providing better services to the poor.

Getting started. The first step was to dissolve the troubled Water District. This step was essential for moving toward a sector structure in which a private operator would take on full responsibility and accountability for service provision. Dissolving the Water District required much political capital and commitment and was possible only after extensive legal and administrative proceedings.

Defining objectives. Three main objectives were set for the proposed project. First, to improve the delivery of water by increasing system pressure through detection and repair of leaks. Second, to expand service coverage to more barangays. And third, to encourage the operator to connect poor households to the water supply system. The proposed OBA approach integrates these objectives and creates the necessary incentives and conditions for the private operator to tap capital markets.

Under this approach the private operator will be responsible for:

- Designing and constructing the water supply system in accordance with technical specifications accepted by the national government and stipulated in the design and construction contract.
- Operating the water supply system for 15 years in accordance with the operation and management contract, which is renewable on the basis of performance.
- Offering connections to all households within the service area of the former Water District and to all those within 20 kilometers of this area. The cost of connections to preidentified low-income households will be financed up front by the government of La Union, through a loan to be repaid through concession fees. The rest of the financing requirements will be assumed by the operator, which will receive the exclusive right to serve consumers in the service area through the water supply system.

Identifying the target population. Identifying beneficiaries is a key step in any OBA project. As part of a process to do so for the La Union project, the barangays conducted household surveys modeled on a national survey designed to identify households unable to satisfy their minimum basic needs (box 1). This process, managed by the provincial government, identified around 8,000 households as eligible for connection subsidies through OBA payments. Women participated extensively in conducting the survey, and the classification of poor households was randomly verified by a consultant.

Setting tariffs. The tariff structure will continue the current practice of distinguishing between two categories of users: residential and government establishments, and commercial, industrial, and other users. For all users except the preidentified low-income households, the operator will charge a service connection fee of $55 and a monthly consumption fee with a minimum charge equal to the price of 10 cubic meters. For the first time in the Philippines, water sector poor households will be exempt from paying the minimum consumption fee and will instead pay for actual consumption.

Box 1 Assessing households' ability to meet minimum basic needs

Since 1995 the Philippine National Statistics Office has conducted an annual nationwide survey to identify households that cannot meet their minimum basic needs. The survey uses 24 core indicators based on the minimum criteria for attaining a decent quality of life, including survival needs (food, nutrition, water and sanitation, basic and reproductive health), enabling needs (schooling, literacy, participation in people's organizations), and security needs (shelter, income, employment). The survey uses a community-based approach, requiring that local volunteers visit each household to complete the questionnaire. The indicators provide policymakers with both inputs and monitoring tools for use in designing and evaluating development projects.

In an attempt to avoid court proceedings in response to a tariff adjustment coinciding with the signing of the concession contract, the tariff level will remain unchanged for two months after the transaction, at $0.27 per cubic meter for residential and government establishments and $0.55 for other consumers.[2] Over the life of the contract tariffs will be adjusted for regular conditions (inflation) and extraordinary conditions (events such as force majeure as defined in the contract). All tariff adjustments must be approved by a contract administration unit to be established at the provincial level.

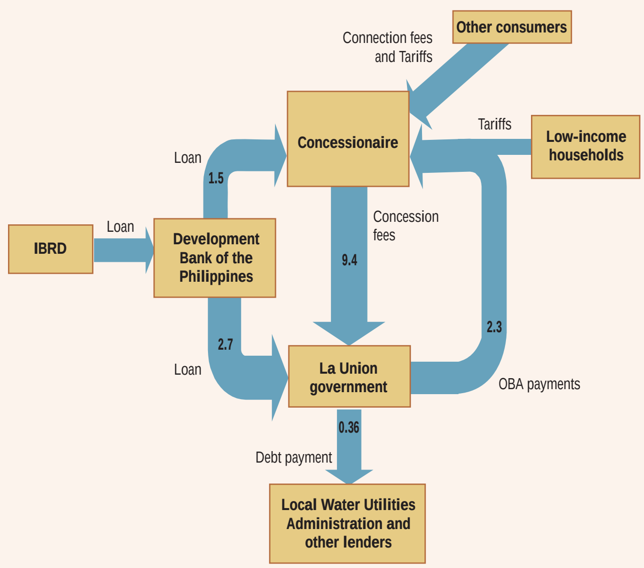
Regulating operations. The operations under the OBA approach will be regulated by contract, primarily through the contract administration unit. This unit will include representatives of the provincial and municipal governments and the Development Bank of the Philippines.

Selecting the private operator. The private operator is being selected through competitive bidding on the basis of the lowest subsidy required per metered connection for targeted households. Eligible bidders prequalified by demonstrating previous experience and financial capacity. They needed to show at least five years' experience in telecommunications, real estate, water services, or electricity distribution—in design, construction, or operation. To prove financial capacity, they could show experience in projects of a similar cost, demonstrating a minimum net worth and minimum gross revenues. In addition, under the Philippine constitution the private operator must be at least 60 percent Filipino-owned at the time of the contract signing.

The bidding process started in 2003, but was delayed by court challenges to the reform brought by the trade unions affected and by local elections. The process resumed in late 2004. A prebid conference held in January 2005 was attended by the two prequalified bidders.

Defining the flow of funds. The total cost of the project is estimated at $11 million. The concessionaire is expected to bring financing of about $8 million, including at least $1.5 million in a direct loan from the Development Bank of the Philippines, to cover most of the required investment (figure 1). Separately, the bank will lend $2.7 million to the government of La Union, which will use $2.3 million to make output-based payments for connections to low-income households and $360,000 to refinance loans that covered existing debt of the former Water District to LWUA. In addition, the service provider will be responsible for monthly concession fees of $20,000 in the first 3 years of operation, and $60,000 in the next 12 years. Part of the concession fees will go to repaying the La Union government's loan from the Development Bank of the Philippines.

Figure 1: The flow of funds (*millions of U.S. dollars*)



Testing the waters: innovative features

Several features distinguish this OBA project from others, including political leadership, the targeting of subsidies, and the sustainability of funding. First, while laws and executive orders allowed local authorities to replace Water Districts with privately managed systems, the governor of La Union was the first to demonstrate the significant political commitment and leadership needed to actually do so. Dissolving the Water District required several difficult steps: securing clearance from the court, obtaining the consent of LWUA, disseminating information to all stakeholders—especially board members and the nearly 100 Water District employees affected—and reaching an agreement among the four municipalities and the capital city of San Fernando. It also required the government to fully repay the Water District's outstanding debt of $360,000 to LWUA (see figure 1). Showing strong leadership, the La Union government has successfully pursued reform despite regulatory turf battles with LWUA and labor disputes with the employees association of the dissolved Water District.

[2] *Philippine society is litigious, and the proposed project has already ended up in court proceedings five times. Thus an initial increase in tariffs was expected to carry high transaction costs.*

Second, heeding the lessons of global experience with private participation, the proposed project is structured to produce clear benefits for the sector and the poor. Earlier reform efforts often paid too little attention to the tariff structure, particularly that for low-income households. As a result, the benefits—in access, quality, and efficiency—were achieved at the cost of a larger burden for the poorest group connected to the services.[3] In addition, the tax and nontax revenues generated through public-private partnerships were not always reinvested in the sector, but often redirected to fill gaps in the government's general budget. By taking a loan to fund connections for low-income households and using concession fees to repay this debt, the government of La Union will ensure that the revenue returns to the sector and directly benefits the poor. The proposed project structure reflects the government's strong commitment to this goal, since the connection charges tend to be incurred early in the concession period while concession fees accumulate over the longer term.

Third, the proposed project demonstrates the possibility of using loans to fund OBA subsidies for the poor. This possibility is particularly relevant for middle-income countries and for their local governments, often perceived as unable to benefit from OBA schemes. Middle income countries usually are ineligible for grants from international financial institutions, which can be used for subsidy payments for low-income households. In addition, many municipalities lack a sufficient tax base to fund subsidies for the poor. In the La Union project the cost will be funded in part through a loan from the International Bank for Reconstruction and Development (IBRD), on-lent to the province at viable interest rates by the Development Bank of the Philippines.

Finally, this example shows the potential of OBA to leverage private funding and expertise to meet the needs not only of low-income households but also of consumers who can afford to pay. Private operators willing to invest in large cities may shy away from investing in water systems in secondary cities, perceiving the market and the demand for services as too small. A government guarantee of payment for low-income households can expand the market far beyond potential paying customers. In La Union, including low-income households increased the market by about 25 percent.

For information on future developments in the project, see the Web site of the Government Electronic Procurement System (*http://www.procurementservice.net*), where updates on the award of the contract and the reason for the award will be posted.

[3] *Antonio Estache, "PPI Partnerships vs. PPI Divorces in LDCs," World Bank, Washington, D.C.; and ECARES, Universite Libre de Bruxelles, 2004.*

About OBApproaches

OBApproaches is a forum for discussing and disseminating recent experiences and innovations for supporting the delivery of basic services to the poor. The series will focus on the provision of water, energy, telecommunications, transport, health and education in developing countries, in particular through output, or performance,-based approaches.

The case studies have been chosen and presented by the authors in agreement with the GPOBA management team, and are not to be attributed to GPOBA's donors, the World Bank or any other affiliated organizations. Nor do any of the conclusions represent official policy of the GPOBA, World Bank, or the countries they represent.

Global Partnership on Output Based Aid
World Bank
Mailstop: H2-202
600 19th Street, NW
Washington, DC 20433, USA

To find out more, visit
www.gpoba.org

GPOBA
The Global Partnership on Output-Based Aid