I. Project Context

Country Context

Kenya is facing economic challenges which may dampen growth in 2012, but it remains above its long term average growth performance. The combination of high food and fuel prices, the drought in the Horn of Africa in 2011, and the Euro crisis have weakened Kenya’s external position. For 2012, the World Bank projects Gross Domestic Product (GDP) growth to recover slightly and reach 5.0 percent. This is lower than in 2010 but much higher than during the recent 2008/2009 crisis and above the 3.7 percent long term average growth performance. If the positive trends continue, Kenya could return to the high growth momentum it experienced between 2004 and 2007, which will be necessary to achieve the goals outlined in “Vision 2030” (V2030) and the Vision 2030: First Medium Term Plan (2008-2012).

Expected events in 2012/13 will be a defining moment in Kenya’s history, while the world is facing the European crisis. The combination of national elections, the establishment of a new system of devolved government and the global economic crisis will make the next 12 months extremely challenging. At the same time, if Kenya manages these challenges well 2012/13 will be remembered as the period in which Kenya began to deliver on the promise of the new constitution.

Political Issues. The August 4, 2010 passage of the new constitution for Kenya was a watershed moment. The new constitution will bring about a number of changes to the political system in the short and medium terms, including in the structure of government and in the legal and judicial systems. The campaign for the next general elections has informally begun, with several high-level figures said to be interested in running for president.

The overall poverty rate in Kenya based on the national poverty line is 46.6 percent, and the extreme poverty rate is 20 percent (as Noted in the Poverty and Inequality Assessment, 2009). These figures are based on the most recent (2005-06) household consumption survey and will be updated using a new survey planned for 2011-12. Poverty is higher in rural areas (50 percent) compared to urban areas (34 percent) and far higher among female-headed households. Overall, income inequality is high in Kenya: the Gini coefficient of 45.2 is similar to that of Rwanda and Uganda and above those of two of its other neighbors, Tanzania and Ethiopia (34.6 and 30 respectively).

Poverty in Kenya is closely associated with poor infrastructure, low income diversification, lack of access to credit and inequality in access to land. The most important drivers for households falling into poverty are various forms of shocks, among them, food price inflation, droughts and floods, illness and death in the family, and death of livestock. Drivers out of poverty are access to key infrastructure such as roads, household income diversification, and access to financial services (Poverty and Inequality Assessment, 2009).

II. Sectoral and Institutional Context

Infrastructure has been consistently identified as a top constraint to growth and to doing business in Kenya. Recent estimates indicate that annual per capita growth could be increased by three percentage points if the country’s infrastructure endowment could be brought to a middle income country (MIC) average. Having made significant progress in infrastructure through the mid-2000s, Kenya boasts infrastructure indicators that are higher than those of most low-income countries in Africa, but well below those of Africa’s MICs. The Africa Infrastructure Country Diagnostic (AICD) report concludes that Kenya faces a large infrastructure deficit, which requires sustained expenditure of almost US$4 billion per year over the next decade (about 20 percent of GDP).

Kenyan businesses are particularly affected by the lack of infrastructure, identified as a top constraint for doing business (see Investment Climate Assessments (ICAs) 2007). Transport is the main infrastructure bottleneck affecting Kenyan firms, including the Mombasa Port, with issues related to terminal capacity and its road and rail interfaces to improve efficiency. Electricity is another major constraint affecting Kenyan firms and the sector needs to double its current capacity over the next decade. The last ICA reports indicate that more than half of the manufacturing firms surveyed reported transportation as a major problem (direct and indirect costs) as of 2007, increasing from 37 percent and 48 percent in 2003, respectively. In contrast, the Information and Communication Technologies (ICT) sector has been substantially modernized generating most of...
the economic growth related with infrastructure in the 2000s. Major institutional reforms in ICT have allowed a revolution in the sector and, as a result, Kenya has achieved one of the highest Global System for Mobile (GSM) communications coverage in Africa (over 90 percent of Kenya’s population lives within range of a GSM signal).

Government strategies and plans recognize and seek to solve Kenya’s lack of sufficient infrastructure. V2030, Kenya’s long-term development strategy, seeks to transform Kenya into a MIC by the year 2030. The strategy sees infrastructure as a key pillar to obtain this goal and identified around US$23 billion in infrastructure investment required through FY2013, about 80 percent of which was expected to come from PPPs. While this target is extremely aggressive, and has not been achieved anywhere in the world, it evidences the importance of PPPs for the Government, and the critical nature of this proposed IDA operation. Kenya’s First Medium Term Plan (2008-2012) for the implementation of V2030, focuses on concrete activities, programs, and projects to improve and modernize the country’s infrastructure, which is conceived as a key “foundation for national transformation.” The plan includes: increased investments (in the road network, water and sanitation, rail, sea and air transport and energy supply services); the legal framework to support PPPs; and institutional reforms in transport. It also includes actions and policies in capital markets to create the enabling environment for long term finance by developing a more liquid long-term Government debt market, market architecture reforms and regulations that support long term instruments such as infrastructure bonds and asset backed securities. Reforms in the pension and insurance sectors designed to foster further growth in both sectors as well as a stronger involvement in long term finance are also under consideration.

Kenya already spends a sizable amount (US$1.6 billion per year) to meet its infrastructure needs, but financing the deficit will be a challenge. The private sector accounts for about half of infrastructure investment (90 percent of which is in ICT), followed by the public sector and development aid (each cover a quarter). Kenya’s AICD report estimates that Kenya’s infrastructure funding gap is about $2.1 billion per year (11 percent of GDP approximately). This funding gap can be addressed only by raising additional resources, adopting lower-cost technologies or less ambitious targets for infrastructure development, while prioritizing infrastructure investments.

The FY2012 budget reaffirmed infrastructure as a priority and the Government has restated that PPPs would be a key financing option to be deployed more systematically. Aside from a series of Independent Power Producers (IPPs) in the energy sector, dating back several years, and the recently restructured Rift Valley Railway (RVR) concession, most segments of the Government of Kenya (GoK) have little experience with PPPs. Moreover, financial support to PPPs from the sovereign government (e.g., revenue guarantees) has been ad hoc, raising the need for systematic contingent liability management, while some progress is ongoing with 4-6 IPPs. While PPPs provide private financing in traditionally publicly financed infrastructure investments, PPPs are a service solution, enabling governments to bring the benefits of private management in public services, typically leading to significant improvements in service quality and coverage.

Kenya’s capital markets rank third in size in SSA (after South Africa and Nigeria) and have promising prospects, but require structural changes to provide sustainable long-term funding. The main challenges are: i) the development of a liquid government long-term yield curve that could serve as a reference to non-government fixed income securities; ii) addressing regulatory constraints to issue efficiently and at lower costs corporate and asset backed securities to institutional investors; iii) supporting growth in the pension and insurance sector, as well as accommodating their investment policies to planned institutional offering regimes; and iv) making available local currency funding products at suitable tenures to finance local currency generating pipeline. The share of domestic government debt over total debt shifted from 30 percent in 2000 to 54 percent as of end-2010 and has extended maximum tenors from 6 years in 2002 to 30 years in 2011, including a series of the so-called “infrastructure bonds”. However, secondary markets are shallow, preventing the consolidation of a reliable medium and a long-term government yield curve. Corporate bond markets, though revamped extensively since 2007, represent only 2.8 percent of GDP as of end-2011. The banking sector dominates the investor base holding 50 percent of Government debt and 25 percent of corporate debt, yet more diversified than most African countries. Nevertheless, there is a relatively large and growing institutional investor base (mutual funds, pension funds, and insurance companies) with assets under management at 25 percent of GDP as of end-2011. Pension fund and insurance companies are already oriented towards non-government long term funding with holdings of 68 percent of outstanding corporate bonds in 2011.

The GoK is seeking to create the appropriate system in the local capital market enabling it to become a sustainable source of long-term financing for infrastructure projects. This strategy is consistent with V2030 objectives to boost savings, support private contractual savings arrangements (pensions and insurance) and enhance the role of capital markets to finance growth. Also, more developed debt markets support financial stability, even in times of stress, as experienced by emerging market economies with relatively efficient debt markets during the 2008 crisis. A more consolidated long term market would support Kenya in both financing development and helping manage events of financial stress. Additionally, the strategy also draws lessons from ongoing developments in both advanced and emerging market economies to have capital markets that can act as a major source of financing for infrastructure and other PPP projects, including pension funds as main investors. Recent interest in Kenya’s PPP sector by foreign investors would also be an opportunity for knowledge and skills transfer. Kenya would be required to adapt lessons learned with different structures and instruments used in other regions (e.g. infrastructure funds, private equity funds, infrastructure bonds, and Sharia compliant instruments) to the specific funding needs of projects and profile of investors.

The GoK is aware of the need to implement reforms to promote the development of a robust market for PPP financing to effect a substantively broader based growth in infrastructure and social investment across sectors in a manner that augments Value for Money (VfM) and enhances governance. The GoK’s first steps to strengthen the legal and institutional enabling environment were the Public Procurement and Disposal (Public Private Partnerships) Regulations, 2009 (PPP Regulations) issued under the Public Procurement and Disposal Act of 2005. The GoK has since published a National PPP Policy, in effect since April 2012. This Policy seeks to further strengthen the legal, institutional and operational framework to achieve these broad PPP market development objectives. The GoK intends to give legislative effect to this framework through a PPP Bill that was submitted to Parliament on May 4, 2012. It entails the following key Governance and VfM reforms and initiatives:

- **Institutional Governance:** The PPP regulations established a new PPP Committee (PPCC) and a PPP Unit (PPPU). These entities are tasked with driving a technical rigorous project development process and providing high level oversight of the Policy’s implementation, respectively. The PPPC is a Permanent Secretary-level body chaired by the Permanent Secretary (PS) of the Ministry of Finance (MoF) and responsible for policy implementation and pipeline approval oversight. The PPPU is considered to be the technical body of the PPPC, headed by a PPP Director who reports to the PS of Finance as chair of the PPPC. The PPPU will be responsible for coordinating with line ministries in the identification and development of PPP projects to financial close. The PPPC and PPPU will be the main partners and implementing agencies for the proposed IFPPP project.

- **Fiduciary Governance:** The GoK will, as part of the PPP Policy, implement significant reforms to the management of fiscal
commitments and contingent liabilities associated with PPPs as well as develop new fiscal instruments - such as the planned Viability Gap Fund (VGF) for transparent financing and reporting on Government funding of PPPs.

- **VfM:** The Policy places great importance on fostering PPP procurement through competitive processes, based on a high level of technical due diligence. It seeks to improve the ability of all governmental agencies to prepare, procure and implement quality PPPs more efficiently and consistently. This entails the development and training of specialized units (referred to as “Nodes” in the Policy) within line ministries to undertake this responsibility.

The effectiveness of these key institutional and technical innovations, which are to be supported under the IFPPP, will be further strengthened by the project’s contribution to enhanced capital markets for infrastructure financing. These changes will – over the longer run – support the creation of new sources of domestic finance for infrastructure development and PPPs in other sectors through the lengthening of yield curves, the growth of corporate bond markets and crowding in of pensions and insurance funds to infrastructure and other investments, while preserving prudential considerations of these institutional investors.

In addition, the World Bank Group (WBG) has been providing technical and logistical support to improve the investment climate and the infrastructure and sector financing framework (including PPPs) in Kenya for several years. The proposed project will build on ongoing technical assistance being delivered by a range of Bank teams and external partners. Recent work includes: (i) a 2009 policy note based on an earlier comprehensive study funded by the Public-Private Infrastructure Advisory Facility (PIIAF) and other analytical work on PPP options in various infrastructure and social sectors; (ii) guidance on pre-screening of PPP proposals and input on potential pipeline of PPP projects (in close collaboration with sector colleagues); (iii) ad-hoc advice on PPP regulatory framework early on, a legal review in 2010, and comments on drafts of the PPP bill and policy; (iv) analysis of public expenditures review (PER); (v) PIIAF funded semi-resident advisor to support the PPPU in place; (vi) technical assistance via the Financial and Legal Technical Assistance Program (FLSTAP) and analytical underpinnings via the FSAP update on capital markets, insurance and pensions together with the Capital Markets Practice of the Finance and Private Sector Development Department; and (vii) technical assistance via FLSTAP together with WB Treasury, on debt management to the Debt Management Department (DMD) located in the MoF and WBG guidance to the DMD on analysis of loan guarantees.

One of the most crucial elements contributing to successful PPPs is the early identification of a strong pipeline of PPP projects. To help in this effort, the FLSTAP supported a consultancy for a firm to undertake a PPP pipeline analysis. As reported in the “Pipeline Analysis of Public Private Partnership Projects in Kenya: Project Screening and Prioritization Report”, a methodology was developed together with the GoK with four steps: identification, screening, prioritizing, and ranking.

- **Identification:** The Identification step is based on questionnaires sent to 125 Ministries, agencies and units, following the PPP Screening Guidance Note prepared by the PPPU covering six categories of questions: Policy & Planning, Public Sector Involvement, Project Specifics, Precedence, Risks, PPP candidate. The consultants held a stakeholders workshop in mid-February 2012 based on responses received.

- **Screening:** Out of these projects, the PPPU together with the IFPPP team undertook a screening exercise and agreed on a subset of about 14 projects to be the long list of possible PPPs that could be supported by the IFPPP. Key input and criteria used for this screening included: (i) further detailed information provided by the Ministries; (ii) the suitability of projects for IDA support (e.g. excluding prisons housing PPPs); (iii) considerations of potential issues arising from implementation of the Constitution (e.g. on water sector projects that may be affected by this process); (iv) ongoing WBG support including “soon-to-start” or ongoing feasibility studies of prospective projects (e.g. two projects being structured by IFC and NUTRIP), and; (v) sectoral relevance for the IDA portfolio;

- **Prioritization:** The GoK then selected six possible first mover projects based on time considerations and potential for readiness, which were submitted to the World Bank to be developed with funding from the IFPPP project. The six potential transactions are listed below, with one change that resulted from further assessment of readiness undertaken during appraisal for the ICT project listed, as indicated during the ROC. It is also noted that all 14 Long-Listed projects are expected to receive some support.

The second phase of the consultancy will entail further analysis of the first movers to help move the preparation process forward (ongoing) and to the extent possible prioritize transactions. The first movers transaction are: (a) Nyali Bridge, (b) Dualling of Mombasa Nairobi-Malaba Road, (c) Jomo Kenyatta Airport (Ancillary Services), (d) Geo-Thermal IPP Menengal, (e) Government Shared Service Center/National Land Information System, and (f) Special Export Zone (SEZ), Dongo-Kundu-Mombasa. It is also expected that in the course of APL Phase I these first movers may change – based on outcome of feasibility studies, private sector demand and/or political considerations.

While this represents the “First Mover” list of the GoK highest priority projects for IFPPP support, it is recognized that this list may change over time – for technical, commercial reasons, etc., or because other priority projects are identified. The IFPPP will also be providing ongoing support for upstream screening of potential projects under consideration to be included in the Government’s PPP project pipeline. This pipeline development will be done in close collaboration with the GoK and build on prior rounds of consultations with key line ministries. Among ongoing WBG investments, partial risk guarantees (PRGs), and advisory services, the following efforts are expected to be key for the development of the pipeline particularly for possible project financing to be provided under the APL Phase II of this IFPPP Program: (i) further IPP initiatives; (ii) the recently approved National Urban Transport Improvement Project (NUTRIP); (iii) IFC advisory for PPPs, including on Kenya University hostels (approved for advisory transaction in December 2011) and the Mombasa Convention Centre (preparations for advisory transaction ongoing); (iv) initial discussions on options for the Jomo Kenyatta International Airport (to MoF) coordinating with technical advice from the project team to KAA.

**III. Project Development Objectives**

The objective of the first phase of this Adaptable Program Lending (APL) initiative is to improve the enabling environment to generate a pipeline of bankable PPP projects.

**IV. Project Description**

**Component Name**

Component 1: Technical Support to PPP Institutions for PPP Legal, Regulatory and PPP Financing Environment.

Component 2: Support for Preparation of Individual PPPs.
VI. Implementation

Institutional and Implementation Arrangements

The MoF PPPU under the authority of a Director will act as overall Implementing Agency for the IFPPP project. The project will be implemented with the support of a PIU reporting to the Director, PPPS. The PIU will be composed of seven staffs (1) Project Coordinator, (2) Financial Management Specialist, (3) Procurement Specialist, (4) Assistant Project Accountant, (5) M&E Specialist, (6) Safeguards Specialist (with specific World Bank expertise), and; (7) PPP Specialist. The PPPU is responsible, under the Policy for coordinating Government implementation, including advisory and oversight functions under the overall governance of the PPPC.

A Project Steering Committee (PSC) will be set up and this function will be developed in terms of roles and responsibilities in the Project Implementation Manual (PIM). It will, inter alia, require Semi-Annual Project Progress Reviews, based on reporting to be prepared by the PIU under the supervision of the PPPU Director. The PSC will be chaired by the PS Treasury and include the Attorney General and the PS of the Ministry of Planning. The PPPU will serve as the secretariat and technical arm of the PSC.

The MoF has made arrangements to use an existing PIU under the MoF, which is currently supporting the implementation of the FLSTAP to undertake the day-to-day implementation of the project. The MoF PIU will be broadened to handle the IFPPP project with support from additional hires to the unit as required. The GoK will benefit from the experience already acquired by the PIU team. The procedures are set and the PIM will incorporate system related aspects (use of client connection, PROCYS), as well as the need to standardize communications among the implementing agencies, the PIU, the PPPU and MoF in order to expedite processing of requests. The PIU will be only an operational unit, with the exception of the Safeguards PPP technical specialists. The PIU will report to the Director PPPU.

Specific PPP technical expertise to be financed by the project will be in accordance with the PPPU organigram and roles and responsibilities. This technical and advisory cadre will be recruited into the PPPU and report directly to the PPPU Director according to terms of contract and the PPPU Business Plan.

Results Monitoring and Evaluation

The PIU M&E Function: Specialists in the PIU will coordinate with the Ministries and Agencies Nodes to ensure that coherent and standard M&E data gathering and reporting systems are in line with the PDO and PDO level and intermediate results indicators established for the project and further explained in the Project Performance Framework. The scope of the work of that unit will cover both phases of the APL. The function also includes coordination with participating line ministries and agencies, and ensuring adequate reporting to the National Development Planning Commission.

It is anticipated that an impact evaluation will be undertaken on the overall APL program. In view of this, the World Bank will work closely with the GoK to develop the baseline data requirements and develop the methodology to effectively conduct the impact evaluation at a suitable time after the results of the overall two-phased program are known. A detailed evaluation plan will be expanded to include, inter alia the development of a relevant baseline – to lay the foundations for the successful implementation of this impact evaluation. This will be done in coordination with the other PPP APL projects being undertaken in the Africa region.

Reviews during implementation support missions by IDA will include formal Annual and Semi-Annual Work program consultations at which time annual procurement and capacity building plans will be subjected to detailed review and approval actions by the PPPU and the World Bank. The PPP PIU will be required to prepare information necessary to inform these implementation review exercises and to ensure that all indicators in the results framework are reported on with recent progress data.

A Mid-Term Review (MTR) will take place 24 months after the APL Phase I Credit effectiveness in accordance with the terms of reference agreed upon by Government/PPPU, the PIU, IDA and other donors involved in the Government’s PPP program and will include an assessment of the triggers identified and clarify whether conditions to move to the second phase are fulfilled. The PIU will prepare the mid-term report detailing implementation progress under all Program components and identifying implementation issues. This report will be submitted to the PPPU, IDA and the other donors involved in the project not later than two months prior to the mid-term review. During the mid-term review, implementation progress and solutions to identified implementation issues will be discussed and agreed on and, if required, project redesign will be undertaken. An Implementation Completion Report (ICR) will also be prepared by IDA - further to the preparation of a Project Completion Report by the PIU and PPPU - within six months after the closing date of Phase I and Phase II operations.

M&E Framework Systems and Reporting: Establish the M&E framework, systems, and operations of the PPP PIU in accordance with the Project’s objectives and strategy. Relevant tasks will include (a) Preparing quarterly, half yearly and annual project monitoring reports, containing summary data on overall performance against targets; (b) Coordinating the organization of annual and semi-annual M&E reviews and lessons-learned workshops to ensure the M&E function enhances the ability to increase project outcomes; and (c) development of the Impact Evaluation Design and Implementation Plan and compilation of baseline data requirements as determined in the design framework.

M&E Participatory Mechanisms: Ensure that an effective and participatory M&E system and methodology are established consistent with a
robust M&E function – this includes: (a) the establishment of “third party” demand-based feedback arrangements (at policy, program and project levels) with civil society and other community interests in line with commitments made during the March/April 2012 Project Stakeholder Meetings for the disclosure of the ESMF and RPF; (b) feedback from wider private sector with a stake in development of the PPP market; and (c) ensure that diversity in participation is respected by allowing space for women, the poorest, and marginalized social/ethnic groups to participate.

Staff and Consultant Management: Depending on workload and resource requirements as approved under the M&E Annual Plan, additional specialized M&E skills will be identified and recruited when/as needed.

Sustainability

Key strategic goals for this project are not just to finance specific PPP transactions but also to help establish a robust and sustainable PPP market. It is anticipated that this will entail: (a) ongoing financial sector reforms coupled with the technical assistance and capacity building supported by this program to foster the deepening of the capital, particularly bond, market; (b) enhancement of the Government’s project development capacity; (c) momentum to push forward ongoing legal, regulatory and fiduciary reforms at the sector level; (d) creation of vibrant support markets for transaction and related services over time; and (e) the establishment of a track record and reputation for well-developed and implemented PPP transactions. Furthermore, the GoK has showed strong commitment and ownership for the PPP Program as represented by the recent passing of the National Policy on PPP and the establishment of the PPPU. Notwithstanding this strong commitment, certain risks still exists. The critical factors associated with this project and how this program addresses these are detailed in the following section.

### VII. Safeguard Policies (including public consultation)

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### VIII. Contact point

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