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Helping Small Water Utilities Become Bankable

Small water utilities with fewer than 5,000 connections comprise over 90 percent of the known network systems in urban areas in the Philippines. By developing their capacity to improve their performance, they have more chances of being creditworthy and bankable so that they can finance investments for expansion and service improvements. The Small Water Utilities Improvement and Financing (SWIF) Project of the World Bank’s Water and Sanitation Program1 (WSP) in the Philippines worked with 11 small water utilities to help them do strategic planning and prepare performance improvement plans and to prepare cost recovery tariffs as well as project proposals that can be submitted to a bank. They can easily reorganize their investment plans to suit available financing. This SmartLesson shares lessons learned by the project team in helping these small water utilities become bankable, including making sure everyone gets training, ring-fencing2 the accounts of water operations, and helping close the gap between what utilities want and what banks want.

Background

As of 2008, 91 percent of Filipinos have access to improved drinking water. The Millennium Development Goals (MDG) target of 92 percent seems to be almost attainable. But with a high urban growth rate of nearly 2 percent, this will not happen easily. Small utilities are faced with the challenge of starting from a low number of connections. And to catch up with rapid urbanization they need to implement successive investment plans that are suited to their financing and management capacity.

A 2004 World Bank WSP project of benchmarking water utilities revealed that small water utilities fund their capital expenditures mostly by internal cash generation and grants that can only fund minor investments. These utilities have difficulty borrowing from banks because they are afraid to borrow or because they have no experience in borrowing. They do not know how to prepare a project proposal, nor do they have collateral that can be used to guarantee their loans. They also find the available bank loan terms in the market,

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1 The Water and Sanitation Program (www.wsp.org) is a multi-donor partnership administered by the World Bank to support poor people in obtaining affordable, safe, and sustainable access to water and sanitation services.

2 Ring-fencing of accounts involves the isolation of water operations from the other activities of the local government so as to be able to generate reliable financial reports showing the true performance of the water utility, generate information that can be used to determine the appropriate tariff, and build a financially viable and self-sustaining water utility.
which have a short repayment period and high interest rate, to be a challenge to their cash flow.

The small utility management and staff then needs to have internal tools to conceptualize, finance, and manage investments and changes continuously. The SWIF Project of the WSP in the Philippines then had to devise an improvement planning system that is driven by the utility rather than externally through a project or through consultants.

The SWIF Project worked with 11 small water utilities to help them identify and develop potential projects linked to their performance improvement action plan\(^3\) that will require financing and to provide an opportunity for hands-on training of utility staff in project finance, planning, and decision making. The SWIF Project, which was implemented from July 2006 to March 2008, helped the utilities improve their performance to enhance their creditworthiness and improve their capacity to prepare project proposals that can be submitted to a bank. Under the project, the recommended tariff model of the government’s National Water Resources Board for water utilities that it regulates was refined and updated.

This model was used by the utilities as a tool to consolidate their business plans for a five-year period and to see the financial results of their targets. The project also developed a guide to ring-fencing water operations for local government-run water utilities. A performance improvement toolkit for small water utilities was prepared by documenting and compiling the process of coaching them. For example, the coaching of the water utility board of directors and staff in strategic planning through the SWOT (strengths, weaknesses, opportunities, and threats) analysis is described in the toolkit, along with steps on how to prepare performance improvement plans. Familiarization with the financial projections model and explanations on tariff setting are also documented.

During their strategic planning, the participating utilities recognized the need to expand their services while improving their performance so that they could reach more people and give them access to piped water. The top investments they planned were for the expansion, upgrading, and rehabilitation of their networks and water source development. There were also commercial systems improvements such as the computerization of their billing and collection system. These were to be funded mostly by internal cash generation after implementing a cost recovery tariff. All of the utilities were assisted in formulating project loan proposals out of their investment plans. Four of the 11 utilities planned to borrow. One of them has already obtained a loan for source development, and another one is in the process of completing the bank’s requirements.

Table 1 shows the overall results of the utilities’ performance from 2007, just before the project was completed, to 2009, the latest data. New connections enabled piped water to reach 10,250 persons. However, their profitability weakened because some of the water utilities could not implement their cost recovery tariff. This is indicated by the operating ratio, which is the ratio between operating expenses and operating revenues. The collection period improved the most because of improvements in the utilities’ billing and collection systems, including disconnection of delinquent accounts. Nonrevenue water (the portion of water production that is not billed or sold) went up slightly as a result of better measurement of actual production.

**Lessons Learned**

1) **Involve everybody in the utility in the training, and the small water utility will be more resilient.**

The 11 participating water utilities are small, with an average of 14 staff only and a very simple organizational structure. Everyone in the water utility was encouraged to participate in the training, which used a participatory and coaching approach, from members of the board of directors to the management and the rest of the staff, including the meter readers, billing and collection clerks, and plumbers.

The training started with a three-day workshop at the water utility’s premises. The first day was devoted to strategic planning using the SWOT analysis where board members were invited to attend. Topics on the second day covered how to prepare a project proposal, how banks evaluate a proposal, and what data are needed to prepare one. This was followed by discussions on an ideal organizational setup for a water utility, the delineation of responsibilities within the organization, internal controls, monitoring and evaluation, and tariff formulation.

Afterward, the participants were segregated into technical and financial groups. The technical group discussed water sources, transmission, storage, and distribution issues; water quality and water treatment; the demand and supply gap; and the costing of capital and operating expenditures. They were guided on how to prepare an investment plan and performance improvement action plan focusing on technical matters like decreasing nonrevenue water, improving water quality and water pressure, and increasing the number of hours that water is available to consumers.

Meanwhile, the financial group also prepared its performance improvement plans related to financial matters, such as how to improve their billing and collection

\(^3\) A performance improvement action plan contains an area of operations that needs to be managed to improve its efficiency and effectiveness, how this will be done, who will be responsible for it, including expenditures and investments that may be needed to effect these changes. Some examples are reducing leakages, improving water quality, and increasing service coverage.

<table>
<thead>
<tr>
<th>Table 1. Selected Performance Indicators, 2007 and 2009</th>
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<tr>
<td><strong>Indicators</strong></td>
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<tr>
<td>No. of connections</td>
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<tr>
<td>Operating ratio</td>
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<tr>
<td>Collection period, days</td>
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<tr>
<td>Nonrevenue water</td>
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Source: Water Utilities Participating in the SWIF Project
system so as to shorten their collection period. Aside from this, the training offered hands-on exercises on financial projections, gathering the assumptions and data needed, including the technical information to be provided by the technical group, where they come from, how they are entered into the projections, how to analyze the results, and how to revise the projections to achieve the desired goals. Then everybody joined in the presentation of the financial projections and reviewed the results of their initial plans to assess if they were doable or overly optimistic. They were taught how to revise their assumptions until they were satisfied with the results.

In order to give utilities confidence in their plans, a customer survey was conducted to confirm that the plans match the priorities of customers and also to understand how much tariff increase their customers can tolerate.

The SWIF team left the utility to improve on their investment plans and performance improvement plans and to draft their project proposals. These were later submitted to the SWIF team for review and comments.

During a subsequent visit, one water utility changed the proposal it submitted at the end of the project because a big supermarket chain would open a branch within its service area, and a real estate subdivision donated its network to the water utility. The head of the technical department could confidently explain how the utility would meet the additional demand from this supermarket and the additional connections. Even the human resources head understood the impact of this additional demand on the utility’s operations. The general manager and chairman of the board knew how much financing they would need for these changes.

A team was composed of a technical and financial consultant and reinforced by counterparts from national government agencies (the Local Water Utilities Administration, the Department of the Interior and Local Government, the Cooperative Development Authority, and the National Water Resources Board).

As a follow-up project, an accreditation project is being developed whereby technical service providers will be accredited by the economic regulator of water utilities, the National Water Resources Board. These accredited consultants can be engaged by water utilities to help them with their performance improvement and with compliance with regulation requirements. Utilities may obtain a loan from a revolving fund to pay for the services of the accredited consultants.

2) Ring-fence the accounts of water operations

In the Philippines, the operations of water utilities managed by the local government are not ring-fenced, and thus the utilities’ performance cannot be measured accurately. To address this issue, the project developed the “Guide to Ring-fencing of Local Government-Run Water Utilities” that shows the steps needed to identify all revenues related to water operations and how to record these for the water utility. Before ring-fencing, it was not easy to know how many water bills were collected, and who had not yet paid their bills. The guide also shows how to identify and record expenses incurred by the other local government departments for water operations and to record these to come up with more accurate financial statements for the water utility. This involved developing the staffing system for the water operations and agreeing on rules on attribution of shared resources. An example is the salary of the municipal engineer, who also heads the water utility. His salary before ring-fencing was charged in full to the Municipal Engineering Department and none was charged to water operations. With ring-fencing, his salary is now prorated between the Engineering Department and water operations. By ring-fencing the accounts of water operations, the municipality is now able to know how much subsidy it is giving the water utility and can have a more accurate basis on which to calculate the proper tariff to charge consumers.

One mayor did not realize until the water operations were ring-fenced that the utility was giving a lot of subsidies for providing water to just a limited portion of its constituents. Now that the mayor is getting a more accurate figure of the actual costs, he is working toward implementing a cost recovery tariff.

The U.S. Agency for International Development has collaborated with WSP-Philippines and the Department of the Interior and Local Government, as well as the Cooperative Development Authority, to help more utilities ring-fence their water operations. So far, five local government-managed utilities and three water cooperatives have shifted to ring-fencing the accounts of their water operations. Another five local government water utilities are currently working on their ring-fencing.
3) **Address the special financing needs of small water utilities by addressing the gap between what utilities want and what banks want.**

It does not always follow that when a water utility is creditworthy and bankable, it can easily obtain a loan from private banks.

In the early stage of the project, banks expressed interest in lending to water utilities. But when the project proposals were ready, banks found that the risk-return profile of small water utilities does not make them a prime market for commercial banks.

Then there is also the availability of grant funds through the congressmen’s countryside development fund. Utilities would rather look for these funds than go to banks. The lesson that is being explored is the use of these grants and development funds to leverage commercial funds.

Four of the eleven participating utilities in the project initially planned to obtain a loan. Only one has actually borrowed so far to fund the drilling of a new well to augment its water source. This is a local government-managed water utility where its collateral is the internal revenue allotment of the municipality from the central government. A rural water supply association is also currently working on complying with the bank requirements for a loan to fund a new well. It took some time for the association to decide and agree to borrow from a bank, which offers a short repayment period and high interest rates. A water cooperative that wanted to expand its coverage was fortunate to obtain grant financing from the local government and the countryside development fund of the congressman in its town so that it does have to borrow for now. The fourth utility, also a cooperative, is still working to get approval of its much-needed tariff increase before it can also borrow for service expansion.

A 2008 study, “Small Utility Access to Market Credit: Lessons and Options,” done under the SWIF Project, cites the differences between what utilities and banks want, as summarized in Table 2. The gap between these wants has to be addressed so that utilities can access funds from the market to be able to improve and expand their operations.

WSP Philippines is conducting a study that will develop options and strategies on lending transactions between rural/thrift banks and small water service providers, using the wholesale facility of the Development Bank of the Philippines that will be established under the World Bank–supported Regional Infrastructure for Growth Project.

**Conclusion**

Small water utilities are important. They represent over 90 percent of all piped water operators in the Philippines. They provide water to areas that the big operators are not serving. But they have very specific challenges. They need to manage continuous growth despite the disadvantage of having a small customer and financing base. The support to them needs to be very tailored and focused on transferring capacity to the organization that will rely on internal capacities for the coming years. And supporting increased internal capacities requires a focus on internal performance evaluation and improvement planning, support for financial systems and ring-fencing, support for improvement plan development and project development, and linking these with financing.

**Table 2. What Water Utilities and Banks Want**

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<tr>
<th>Utilities Want</th>
<th>Banks Want</th>
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<tr>
<td>• Longer tenors matched to asset life</td>
<td>• Tenors matched to liabilities (sources of funds)</td>
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<tr>
<td>• Fixed interest rates to manage fluctuations in tariffs</td>
<td>• Floating interest rates matched to market price,</td>
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<tr>
<td>• Smaller loan amounts; multiple drawdowns</td>
<td>variable discount rates and reserve requirements</td>
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<tr>
<td>• No real estate mortgage collaterals</td>
<td>• Adequate spreads and economic size</td>
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<tr>
<td>• Assistance for investment planning and project development</td>
<td>• Low credit risk</td>
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<tr>
<td>• Investment proposals that breed confidence</td>
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