

Sustainable Services for Domestic Private Sector Participation

Using Credit Ratings to Improve Water Utility Access to Market Finance in Sub-Saharan Africa

February 2012

INTRODUCTION

Despite considerable public investment in water supply, access to services in sub-Saharan Africa remains low. In Kenya for example, urban water utilities provide services to 40 percent of the urban population.¹ Access to finance is often a key constraint to extending coverage to unserved consumers, especially as utilities have traditionally relied on government and development partners to finance capital investments. These resources are limited and the additional investment needs are too large to be funded from public sources and utility surplus revenues alone. Yet investments made in the extension and rehabilitation of distribution networks can often generate financial returns to cover the investment costs where cost recovery tariffs are employed to cover operating and maintenance (O&M), capital investment, and debt service costs. Furthermore, developments in financial markets provide opportunities for utilities to access medium-term commercial debt to finance investments with positive return.

PROBLEM STATEMENT

In spite of considerable liquidity within the private financial sector, banks have been reluctant to lend to water utilities for a number of reasons:

- Water is often viewed as a social good with little ability to generate financial return
- Banks in sub-Saharan Africa do not lend for periods beyond seven to ten years, whereas the useful life of water assets is often much longer
- Water assets provide only limited collateral to lenders because they have little liquidation value
- Utilities, due to limited commercial borrowing occurring in the sector, are often not conversant with the lending criteria of commercial banks

As a result, the creditworthiness of water utilities and their investment projects is often opaque to borrowers and lenders alike.

Key findings

- Cost recovery tariff policies create opportunities for water utilities to access medium-term commercial debt to finance capital investments with positive return.
- Credit ratings can support investment-grade utilities to access finance from domestic markets, as they give lenders an objective overview of risk. They also allow utilities to identify areas for improvement and to exchange good practices.
- Public finance and grants should be leveraged to attract investment from domestic financial markets. This leverage can help increase the overall investment potential, reduce risk to commercial lenders, and allow for a rational allocation of public funds to pro-poor projects.
- Utilities must take the lead in identifying and preparing viable projects for appraisal by commercial lenders, and seek the necessary internal approvals to borrow.

¹Water Services Regulatory Board coverage data for 62 urban utilities 2009-10 (8.1 million people with access in population area of 20.5 million); as cited in *IMPACT Report*, Issue no. 4 (2011). Available online: http://www.wasreb.go.ke/images/stories/documents/WASREB_Impact_Report4.pdf

ACTION

Since 2007, the Water and Sanitation Program (WSP), with support from the Public Private Infrastructure Advisory Facility (PPIAF), has been working with utilities to improve access to market finance. As a result of this partnership, a mechanism to assess utility creditworthiness was developed. The mechanism rates utilities according to internal factors, such as financial and credit management, management quality and capacity, and operational performance. It also measures external factors, including economic base, susceptibility to external shocks, and changes in sector policy. Seven utilities in Senegal, Tunisia, Burkina Faso, Uganda and Kenya were assessed and assigned credit ratings in December 2008. On a domestic scale, where the government of the country of operation is AAA-rated, the utilities were assigned investment grade ratings from BBB to A+2 as shown in Table 1.

In 2011, WSP, in collaboration with the Water Services Regulatory Board (WASREB), launched a credit assessment of 43 utilities in Kenya using a similar methodology and assigned shadow credit ratings. Shadow ratings are primarily used for diagnostic purposes and to test how financiers might evaluate a company's credit standing. The assessment resulted in thirteen utilities receiving an A or BBB rating (considered creditworthy) and another sixteen receiving a BB rating (potentially creditworthy) as shown in Figure 1. Fourteen utilities in the "No Rating" category have difficulty remaining solvent and require substantial reforms before financial markets will advance them debt finance. One BBB-rated and one BB-rated utility are currently seeking commercial finance for infrastructure projects, as discussed in Box 1.

Box 1: Utility Projects Accessing Medium-Term Commercial Finance in Kenya

The International Finance Corporation is currently appraising two water and sewerage projects, developed with support from WSP and PPIAF, for ten-year domestic currency loans at market interest rates. Malindi Water (BBB-rated) is seeking to raise US\$4 million to undertake a service coverage expansion project targeting 103,000 residents. The International Development Agency is supporting the project with a concessional loan of US\$2 million. Embu Water (BB-rated) is seeking to raise US\$3 million to finance a sewer network and treatment works to serve 40,000 people. In addition to project revenues, investment in Embu's water supply financed by external partners will help the utility generate sufficient cash to repay the loan. The rating process helped identify management and operational weaknesses to be addressed as part of the proposed lending. The projects are critical in demonstrating the ability to leverage concessional finance to access commercial debt.

KEY LESSONS

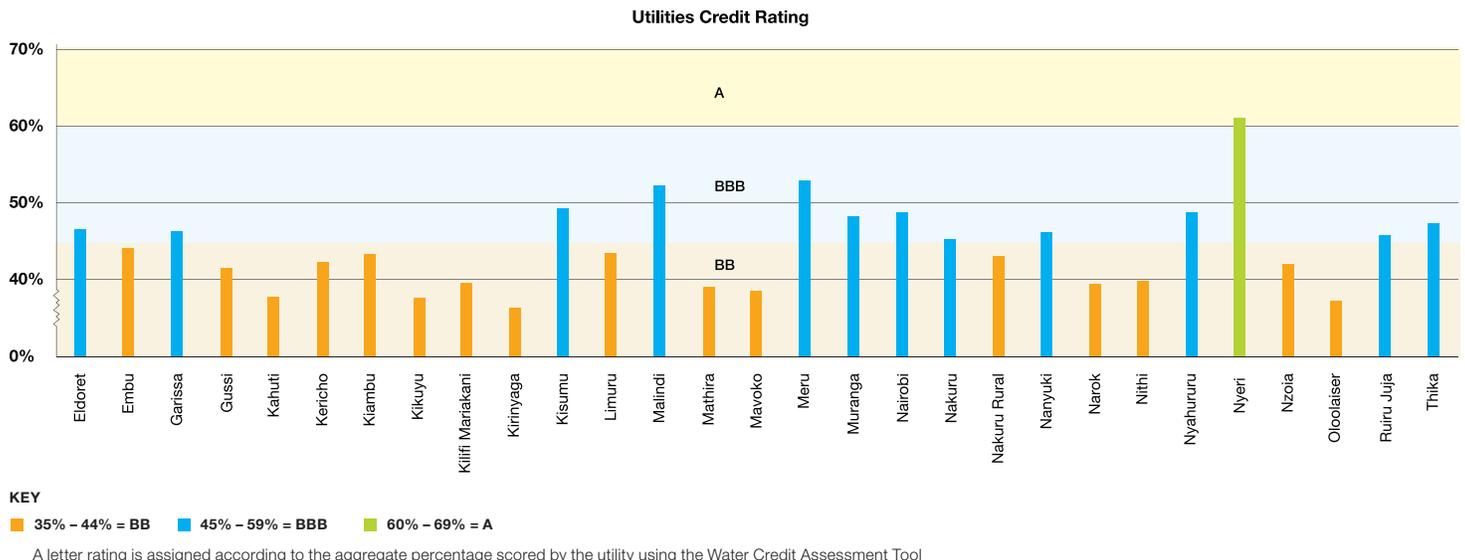
Key factors that impact utility creditworthiness

The following factors were key in assigning investment-grade credit ratings: Cost recovery tariff policies, annual tariff indexation (Uganda), low distribution losses (Senegal, Tunisia and Burkina Faso), and low existing levels of debt (Kenya, Uganda and Senegal). Significantly, utilities with better

Table 1: Ratings Assigned by Global Credit Rating Company to Seven African Water Utilities

Name	Short term rating	Long term rating
Athi Water Services Board	A2	BBB+
Nairobi City Water and Sewerage Company	A3	BBB
National Water and Sewerage Corporation	A2	A
Office National de L'eau et de L'assainissement (ONEA)	A2	BBB+
Sénégalaise des Eaux (SDE)	n.a	n.a
Société Nationale des Eaux du Sénégal (SONES)	A1	A+
Société Nationale d'Exploitation et de Distribution des Eaux (SONEDE)	A1-	A

²Investment grade is \geq BBB-

Figure 1: Shadow Credit Rating of Kenyan Water Utilities

ratings had lower non-revenue water and higher metering and operating cost coverage ratios.

Notably, utilities in both sets of credit assessments were not assigned high ratings typically associated with being virtual monopoly providers of an essential good, as they face some challenges, amongst which are: low surplus cash to fund capital expenditure; poor working capital management exacerbated by significant delays in collecting receivables; apparent weaknesses in management systems; and slow implementation of full cost recovery policies.

Investments should be sized to fit the debt capacity

When using commercial debt to finance infrastructure, capital investment plans should fit the debt absorption capacity of the borrower. Lenders will normally require a debt service cover ratio of between 1.5 and 2 to cover risks arising from shocks and changes in input costs.³ Utilities borrowing from the market will need to consider scaling back or phasing investments to match the financial resource envelope.

Commercial debt should be blended with financial support from the public sector

The ability of utilities to raise all the financial resources needed for investment is very limited, hence public finance and grants

from development partners should be leveraged to attract investment from domestic financial markets.

A flexible loan security structure can be adopted by lenders

Lenders are interested in securing cash flow from borrowers' projects. Therefore, projects that demonstrate sufficient debt service cover secured by a loan structure — that provides the lender with first right to residual cash after essential operating costs have been met — may be used to secure debt finance. A legal and regulatory framework that supports financially sound autonomous utilities is therefore essential.

Utilities must take the lead in identifying and developing viable projects for financing

Ideal projects for commercial financing will generate sufficient revenue to repay the debt used to finance them. These are likely to be tertiary investments in network densification and expansion, metering, non-revenue water reduction, energy efficient investments, and non-capital intensive source augmentation and treatment.

³Debt Service Cover Ratio is generally calculated as: Net cash after operating and maintenance expenditure and tax/debt service (principal + interest).

CONCLUSION

Encouraging creditworthy utilities to finance a portion of their investment program using commercial debt will improve the allocation of public funds for investment. Budget allocations, grants, and concessional loans from development partners can be freed up for non-commercially viable investments, such as water resource development, storage, treatment, and expansion into areas where poor consumers cannot afford cost recovery tariffs. Commercial debt also brings governance benefits in the form of additional oversight from lenders that help utilities improve capital expenditure planning, operating efficiency, and financial management. The management teams of creditworthy utilities need to take up the challenge of preparing projects for financing and seeking support from their boards of directors to borrow. Technical assistance to support deal structuring and development of bankable projects is essential in the early stages of developing commercial infrastructure financing concepts.

Looking forward, the credit rating exercises are expected to open

opportunities for utilities to access domestic credit on commercial terms, especially as banks now see the water sector as a potential partner, where they had previously perceived it as high risk. Additionally, benchmarking through credit ratings provides opportunities for utilities to identify areas for improvement and to exchange good practices, and it can also support regulatory efforts to improve sector governance and planning. Taking steps to address performance issues that hinder access to credit could see significantly more investment in water by the private sector, resulting in improved access in urban areas.

RELATED READING

WASREB/WSP. *Financing Urban Water Services in Kenya – Utility Shadow Credit Ratings*. Nairobi: WASREB/WSP, November 2011.

Global Credit Rating Company. *African Water Utilities Regional Comparative Utility Creditworthiness Assessment Report*. Nairobi: WSP/PPIAF, December 2008.

Acknowledgements

About the author:

Rajesh Advani is a Finance Specialist with the Water and Sanitation Program and is based in Nairobi, Kenya. He has been working on projects to improve utility access to market finance, leverage public funds and grants for infrastructure investment in urban and rural water supply, and develop small scale PPPs.

Peer reviewers: Alexander Bakalian, Jeffrey Delmon, Laura Vecvagare, Jemima Sy (World Bank Group)

About the project

With an estimated US\$26 billion needed between 2005 and 2014 to reach the MDGs in water and sanitation, WSP is working to leverage domestic private sector expertise and resources to deliver services that benefit the poor. The aim is to help an estimated 1.5 million poor people gain sustained access to improved water supply and sanitation services and leverage over US\$80 million in investments by donors, governments, and the domestic private sector through three main activity lines: building water and sanitation business models for the poor; Public-Private Partnerships in non-traditional markets; and, banking the unbanked water and sanitation providers. For more information, please visit www.wsp.org.

Contact us

For more information please visit www.wsp.org or email Rajesh Advani at wspaf@worldbank.org.

ABOUT WSP

WSP is a multi-donor partnership created in 1978 and administered by the World Bank to support poor people in obtaining affordable, safe, and sustainable access to water and sanitation services. WSP's donors include Australia, Austria, Canada, Denmark, Finland, France, the Bill & Melinda Gates Foundation, Ireland, Luxembourg, Netherlands, Norway, Sweden, Switzerland, United Kingdom, United States, and the World Bank.

WSP reports are published to communicate the results of WSP's work to the development community. The findings, interpretations, and conclusions expressed herein are entirely those of the author and should not be attributed to the World Bank or its affiliated organizations, or to members of the Board of Executive Directors of the World Bank or the governments they represent.