PRIVATE FINANCE IN KENYA

Pooling resources to bridge Kenya's funding gap

The $400 million funding deficit in Kenya's National Water Master Plan will need to be met from sources other than the public purse. A new pooled water facility could go some way to taking up the slack.

The Netherlands Water Partnership is setting up a pooled bond facility that will source long-term finance from the Kenyan capital markets to on-lend to local water utilities.

The first bond under the Kenya Pooled Water Fund (KPWF) could take place in mid-2017, following the completion of a business plan in September 2016. "The first issuance will be a relatively modest volume, between $25 million and $40 million, in Kenyan shillings, and we'll then do an annual issuance of over $50 million," says Jean-Pierre Sweerts, project leader at KPWF. The bonds would be rated and listed on the Nairobi Securities Exchange.

Each issuance would be raised to fund a portfolio of projects. Institutional investors would buy bonds with a 10-15 year tenor at the risk-free rate "plus around 1% to cover the additional risk," says Sweerts. The interest rate at which the funds would be onlent to utilities has not been set yet, although KPWF hopes to attract viability gap funding from development finance institutions to ensure the lowest possible rates for utilities. "Even if that didn't happen, the annual debt service would be lower than commercial bank loans thanks to the longer tenor," Sweerts says.

Roy Torkelson, a financial consultant working with KPWF, says that pooled bond facilities have worked well in emerging markets such as India, the Philippines and Colombia. "Wherever they have been set up, they have been highly rated, and to my knowledge, there has been no default," he told GWI. "There is a long history of these structures working, and the beauty is that they can be tailored to the legal and institutional framework of each country."

KPWF has been consulting extensively with stakeholders, and Sweerts says that there is appetite from both utilities and institutional investors for the scheme. The Kenya National Water Master Plan, published in 2014, estimates a need of KES100 billion ($976 million) to achieve its Vision 2030, with anticipated public funding of just KES60 billion ($585 million). Raising money from institutional investors would go some way towards bridging the gap, he maintains.

Torkelson says that consultation is important to ensure "non-impairment" through government policies that could undermine the efforts of emerging private finance initiatives such as the establishment of a national development bank (something that happened in Brazil in the 1990s and derailed the private water finance sector) or a large public investment programme. Another concern is Kenya's pending Water Bill: Sweerts says it's important that a vote takes place (which could happen in September/October) to boost investor confidence, and so that KPWF knows where it stands with regard to the legal framework.

One challenge in Kenya will be to generate enough projects to keep the market liquid, a lesson learnt from previous experience in Tamil Nadu in India. "[The state] did a good job [with its first issue] in 2002, but they didn't do another issue for 6-7 years. It was a buy-and-hold bond, but some investors also look at selling and making other investments," said Torkelson. KPWF hopes to encourage secondary market liquidity by issuing new bonds on a regular basis.

Despite the good intentions, only a handful of Kenya's 117 water utilities are currently in a position to consider private finance. The Creditworthiness Index, a financial assessment tool developed by the World Bank and Kenya's Water Services Regulatory Board (WASREB), has identified 13 potential investment-grade utilities deemed capable of servicing external debt. KPWF is focusing on these utilities for the time being, and is helping them develop a pipeline of bankable projects. "One of the lessons we learnt is that technical assistance is continuously necessary," says Torkelson.

The World Bank, which is working with KPWF, has been piloting the introduction of commercial bank loans since the late 2000s. Although successful, they are relatively small, focus on poor areas, and are supported by partial guarantees and output-based subsidies. Willis Ombai, chief manager for investments and programmes at the Water Services Trust Fund (WSTF) ▶

COMMERCIAL LOANS TO KENYAN WATER UTILITIES

The take-up of commercial bank loans under a World Bank-led programme was slow to take off initially. As the concept has gained traction, interest from utilities has already exceeded the available grant funding.

Utility	Bank	Size (KES m)	Loan tenor	Annual interest	Subsidy to date (KES m)	Date disbursed
Murang'a South	K-Rep Bank	17.6	12-month grace period; 60 monthly instalments	17%	12.5 (full subsidy paid)	January 2016
Murang'a	K–Rep Bank	36	12-month grace period; 48 monthly instalments	20%	7.6 (part payment of 60% subsidy)	March 2016
Nol Turesh	K-Rep Bank	100	12-month grace period; 48 monthly instalments	20%	6.6 (part payment of 60% subsidy)	March 2016
Meru	K-Rep Bank	105	12-month grace period; 60 monthly instalments	16%	No subsidy paid to date	Not yet disbursed
Embu	HF Group	79.6	6-month grace period; 60 monthly instalments	17%	42.8 (full subsidy paid)	April 2015

Source: Water Services Trust Fund

– the entity managing the subsidies – says the incentives were designed to lower the risk of commercial lending, whilst giving both utilities and lenders the chance to familiarise themselves with new funding processes.

Under the system, utilities which manage to secure a loan can apply for an output-based subsidy covering 40% to 60% of the loan value. Upon completion of the works, the subsidy is disbursed, which leaves the utility with only 40% to 60% of the loan value, plus interest, to repay over the remainder of the loan's tenor.

Five utilities have so far negotiated loans with a total value of KES338.2 million ($3.3 million), as well as KES69.5 million ($678,000) worth of subsidies (*see table opposite*). Ombai says that the initial take-up was slow, although utilities now realise the benefits of being able to access commercial finance. The WSTF has a live pipeline of 12 projects (some utilities have applied for more than one loan), and the programme's KES1.3 billion grant (financed by the Swedish International Development Agency, SIDA, through the World Bank and KfW) – which was due to last until June 2018 – has already been oversubscribed.

A pooled bond facility would offer utilities access to longer-dated funding than is traditionally available in the commercial bank loan market, and while Ombai says that this is a good idea in principle, he is concerned that the water sector is not sufficiently mature to take on debt with longer repayment horizons. Sweerts concedes that these concerns are fair, but adds that incentives could be put in place with bonds – such as a reserve fund and partial guarantees – just as they have been with commercial bank loans. "If the first issuance goes well, we plan to lower the guarantees on the second," he indicated to GWI.

Torkelson says that they are also looking into various credit enhancement features. Government transfer intercepts, a US practice whereby funds from central to local government can be used in case of a default, are not possible in Kenya. But the repayment system used in Tamil Nadu could work: instead of making a single payment each year to cover interest and principal amortisation, utilities are required to pay it in nine monthly instalments over the course of each year of the bond's life into an escrow account. "That way, we can monitor whether utilities are having difficulties and fix the problem before the annual payment is due," says Torkelson.

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> Roy Torkelson, consultant to KPWF

With effect from 2016, the Creditworthiness Index will be featured in WASREB's annual Impact report, and both Ombai and Sweerts hope that this will encourage utilities which are currently considered subinvestment grade to implement reforms such as improving tariff collection and billing efficiency and undertaking NRW reduction programmes, which could ultimately increase the take-up of private finance. ■