Theme	**5. FINANCE**
Topic	**5.1 Sustainable Mean of Financing Local Water Authorities**
Main Question	How local utilities expand their overall sources of financing and financial efficiency though their relationship with local governments?
Related sub-questions	Question 1: How can local governments become more reliable financial stakeholders, create incentives for utility managers to make more productive investments to expand coverage and improve service, and allow utilities become more creditworthy borrowers? Question 2: Should local water authorities be allowed to access private finance and under what circumstances? What financing policies can promote an easier transition from public to private sources of financing? Question 3: Bridging the Financing Gap – How Should Subsidies be Utilized to Promote Efficiency and Incentives for Promoting Greater Cost Recovery Through User Tariffs? Question 4: When is decentralization not the preferred institutional option for water supply and sanitation services to local communities?
General introduction	The devolution of governmental responsibilities to the state or local level is perhaps one of the most important external processes affecting water utilities. These affect a wide range of factors including ownership, economic and service standards regulation, the appointment of key management and corporate oversight bodies, financing and other governance issues. On the positive side, decentralization renders government more closely accountable to the communities they serve as water supply and sanitation is very much a local infrastructure service. Decentralization also creates an opportunity to benchmark performance between municipalities and to introduce healthy competition between them. It also provides the opportunity to introduce reforms to selected and willing utilities only, providing a model for others to follow suit. If structured correctly, decentralization creates opportunities to balance powers between central and local governments and thus reduce conflict of interest concerns. However, the challenge lies in making decentralization work, especially in countries where local capacity is extremely weak. Decentralization of WSS services is seldom a studied response to specific sectoral problems but rather, the by-product of a wider reform of the state. During rapid decentralization, local governments are often required to step up their involvement and influence, becoming the owner of a utility as well as a key policy maker. However, in many situations, local governments are not provided with adequate resources, generally lack the institutional and financing capacity to assume these new responsibilities. What commonly results is a general deterioration of the situation as local governments come to view their newly acquired utilities as a supplemental source of income rather that a financial responsibility to scale up service levels to the community. *Resulting Question No. 1: How can local governments become more reliable financial stakeholders, make more productive investments to expand coverage and improve service, and become more creditworthy borrowers?* -- The ability of governments to mobilize financing for sizable investments has a very direct impact the expansion of service and improvement of performance. Public financing in many developing countries is scarce or entirely unavailable. It is rationed among a number of sectors and purposes since many governments face pressing and competing demands for direct budget allocations.

Poorer nations also face severe constraints on their overall capacity to borrow and despite the need, not all investments can be undertaken. As such, a public utility's financing capacity is closely linked to government's overall credit standing since this will dictate the absolute amount of funds that can flow to the sector and to a given publicly owned utility within that sector. Moreover, since infrastructure is one of the few discretionary spending categories, it tends to fluctuate widely in times of economic hardship.

Many countries are indeed trapped into a "fiscal squeeze" which renders large investments almost impossible due to the absence of available domestic funds and the constraints in sourcing debt from international institutions.

Private capital markets in many of these countries are also not adequately developed to source long-term domestic funds and thus, whatever debt can be raised is usually in foreign exchange and carries significant exchange rate risks. So where the opportunities for finance in developed countries are significant, for the developing nations those options are few. In many countries, long-term financing may not be available, and sources of funding, primarily debt would have to be mobilized through on-lending of funds from Official Development Assistance (ODA) including IFI lending. Over time, such financing can be blended with locally sourced financing, which could be backed by guarantees on refinancing or other enhancements. Donor grants and loans are a minor, but important financing source for water infrastructure in developing countries as it also brings with it a governance oversight that may be lacking in the country environment.

Expanding the total sources of financing available to local utilities can be extremely important for bridging the financing gap. Involving international and local banks that operate under commercial principles can bring in a significant element of governance that normally does not exist in traditional public financing between national and sectoral agencies. Local banks could play a more significant role in the financing of water infrastructure by participating as lenders and guarantors. However in some cases, local government and utilities have greatly overextended themselves by borrowing locally, and even with the blessing of federal governments. Then how can governments ensure financial prudence and effective liability management. How can local governments on their part, develop better management practices, particularly in financial management and investment planning. In parallel, how can national governments provide effective oversight?

Resulting Question 2: Should local water authorities be allowed to access private finance and under what circumstances? What financing policies can promote an easier transition from public to private sources of financing?

When decentralization takes place very few local governments have either the financial or management capacity to be effective development agents. Moreover, financing from all sources is largely confined to the largest cities, leaving smaller rural towns with very few financing choices, in terms of either debt or equity. Also, the largest cities typically receive the greater share of both fiscal transfers and other financing despite the fact that large cities also have more capacity to raise financing on their own. With a relatively wealthier class, large cities have substantially greater capacity to raise revenue from property and business taxes, license fees and other miscellaneous revenue.

Such a framework does little to foster development of local infrastructure in the poorer and more remote parts of the country. In order to better balance the finance opportunities of the smaller and poorer local governments, the financing framework for inter-governmental transfers needs to be structured to make a greater relative allocation to smaller and poorer towns for financing a critical mass of basic local infrastructure services including, water supply and sanitation. These allocations to smaller towns can then be utilized to leverage additional sources of financing from donor agencies and lending institutions. This realignment in the inter-governmental transfers would also force larger cities to rely more on their own internal sources of revenue from property and business taxes.

	In a review of the situation in the Philippines for example, it was found that approximately 70% of local governments had annual incomes below P20 million (approximately $380 thousand), hardly enabling them to invest in new capital outlays and development projects. The studies showed that most local governments, particularly the smaller and poorer ones spend only from 8% - 11% of their total revenues for development projects, spending the remainder on salaries and maintenance and operating expenses. Moreover, these same municipalities tended to invest their scarce capital in business enterprises rather than basic infrastructure service for the simple reason that these businesses could generate additional revenue. Also, many central governments have not effectively uses their grants effectively to local governments, focusing mostly on bailing out poorly performing utilities. *Resulting Question 3: Bridging the Financing Gap – How Should Subsidies be Better Utilized to Promote Efficiency and Incentives for Promoting Greater Cost Recovery Through User Tariffs?* -- Problems arising from decentralization are evident in all continents. In Asia, countries including Pakistan, the Philippines and Indonesia undertook drastic decentralization programs in the 1990s. In these cases, decentralization has not brought about a noticeable improvement of local infrastructure services to the communities and many towns, particularly smaller ones do not have the critical mass of financial resources to undertake the new responsibilities. Smaller town centers are often left with uneconomic systems and low capacity combined and with added financial challenges. Smaller utilities, particularly those serving a population of 135,000 or less have higher per-customer operating costs. In Latin America, decentralization preceded WSS sector reform by a number of years. Rapid decentralization after the political turnaround in Eastern Europe and Central Asia devolved the responsibilities to lower tiers of government while financial means and capacity mainly remained at the central level. In Africa the picture is more mixed, with some – mostly francophone – countries remaining relatively centralized and others decentralizing rapidly such as, Ethiopia and Tanzania. *Resulting Question 4: When is decentralization not the preferred option for water financing supply and sanitation services to local communities?*
(Types of) Organizations to be involved in topic consultations	National Governments (min of finance/economic affairs/ infrastructure/public works) National regulators: from developing and industrialised countries Local governments Service providers: private, public, local, international Users: Consumer associations Organised civil society: associations, NGOs, international and local Multilateral donors: WB, EIB, EBRD, AfDB, ADB, IADB, IDB, Bilateral donors Private financiers: Banks, specialised funds Foundations: Gates, Rockefeller Micro-finance institutions: Research Institutions International Agencies
Process of paper and session	1. Draft 1 of topic scoping paper to be sent to key institutions for comments 2. Improved draft to be placed on website

development:	3. Improved draft with comments received to be discussed at the February coordinators meeting to: a. Agree on key questions b. Agree on the topic document so that it can be placed on the Forum web-site c. Agree on key stakeholders to take part in the development of the topic d. Agree on consultation process: relevant meetings with key stakeholders e. Agree on the process and actors to develop the forum session.