

# Progress-Linked Finance: a study of the feasibility and practicality of a proposed WASH financing approach

This report assesses the feasibility of a financing model, Progress-Linked Finance (PLF), designed to incentivise and support water, sanitation and hygiene (WASH) service providers to meet the needs of poor urban residents in a financially sustainable manner. Under the PLF model, international financing institutions (potentially including multilaterals, bilaterals, and foundations) would enter into commitment agreements with urban WASH service providers, notably utilities and municipalities.

In very simple terms, PLF can be summarised as an agreement of the following type: “If the service provider can demonstrate 3 years from now that they have met conditions A, B and C in relation to financial viability and pro-poor commitment and capacity, the financing institution will provide a grant or loan of amount X for WASH scale-up”. In reality, agreements would likely be more complex, for example entailing a series of agreements involving a number of financing institutions. Central to the model is positive incentivisation coupled with rigorous verification that conditions have been met.

On the basis of desk analysis and wide-ranging interviews with urban WASH financing experts, this initial assessment finds that the PLF concept is broadly feasible. We explore different variants of PLF, and suggest various ways in which the concept might be put into practice.



*This Discussion Paper is co-published by Water & Sanitation for the Urban Poor (WSUP) and the Overseas Development Institute (ODI). This paper is presented at this stage as a basis for sector debate, and should not be considered a definitive statement of the views of either WSUP or ODI.*

## Contents

Summary	3
Abbreviations	7
<b>1. Introduction</b>	<b>8</b>
<b>1.1</b> The challenge of bringing WASH services to poor urban residents	<b>8</b>
<b>1.2</b> Using finance to leverage change: introducing the Progress-Linked Finance approach	<b>10</b>
<b>2. What is the need for a PLF approach?</b>	<b>13</b>
<b>2.1</b> Situating PLF in the financing landscape	<b>13</b>
<b>2.2</b> Does PLF have a distinct niche?	<b>18</b>
<b>3. The P in PLF: Progress</b>	<b>19</b>
<b>3.1</b> Who is involved? Parties to a PLF agreement	<b>20</b>
<b>3.2</b> What is involved: what constitutes progress, and how is it agreed?	<b>25</b>
<b>4. The L in PLF: Linking</b>	<b>32</b>
<b>4.1</b> Architecture and operating principles for PLF	<b>32</b>
<b>4.2</b> Supporting and verifying progress	<b>35</b>
<b>5. The F in PLF: Finance</b>	<b>38</b>
<b>5.1</b> Sourcing and sequencing Progress-Linked Finance	<b>38</b>
<b>5.2</b> Utilising Progress-Linked Finance	<b>39</b>
<b>6. Progress-Linked Finance: piecing the puzzle together</b>	<b>41</b>
<b>7. Conclusion and recommendations</b>	<b>43</b>
References	49

## Summary

<sup>1</sup> WHO/ UNICEF. (2010). *Progress on Sanitation and Drinking Water: 2010 Update*. New York; Geneva: UNICEF/ WHO Joint Monitoring Programme.

<sup>2</sup> UN-HABITAT & WHO. (2010). *Hidden Cities: Unmasking and Overcoming Health Inequities in Urban Settings*. Nairobi, Kobe: UN-HABITAT & WHO.

<sup>3</sup> Foster, V., & Briceño-Garmendia, C. (2010). *Africa's Infrastructure: A Time for Transformation*. Washington, D.C.: World Bank.

Water and sanitation service providers are struggling to keep pace with rapid urban growth. In South Asia, South-East Asia and Sub-Saharan Africa, utilities now serve a smaller proportion of the urban population than they did in 1990. In the latter two regions, increases in sanitation coverage are only just keeping pace with urban population growth.<sup>1</sup> And it is the poorest that are losing out: across Africa, only half of people in the poorest fifth of the urban population have access to piped water, while for the richest fifth the proportion is closer to 90%.<sup>2</sup> The size of the annual financing gap to meet the water supply and sanitation MDGs has been estimated at almost US\$12 billion for Sub-Saharan Africa alone, and a substantial proportion of this is in urban areas. At the same time, US\$3 billion of this sum could be recouped by enhancing service providers' operational and commercial efficiency (including cost recovery), underlining the need for continued public financing while encouraging service providers to reform.<sup>3</sup>

Service providers are trapped in a vicious circle of limited customer bases, low revenue, and declining levels of service, which in turn does little to encourage existing customers to pay their bills. Meanwhile, urban poor residents, despite already paying significant amounts to informal service providers, are excluded because formal providers perceive them as high risk, and/or lack the funds and pro-poor management capacity to extend their networks to reach them. The challenges of financial sustainability and institutional capacity to serve the poor are deeply intertwined, and require better incentives and smarter finance.

This report assesses the feasibility of a financing model, Progress-Linked Finance (PLF), which is designed to incentivise and support water, sanitation and hygiene (WASH) service providers to meet the needs of poor urban residents in a financially sustainable manner. The model has been developed by Water and Sanitation for the Urban Poor (WSUP); the present report was produced by the Overseas Development Institute (ODI) in consultation with sector experts.

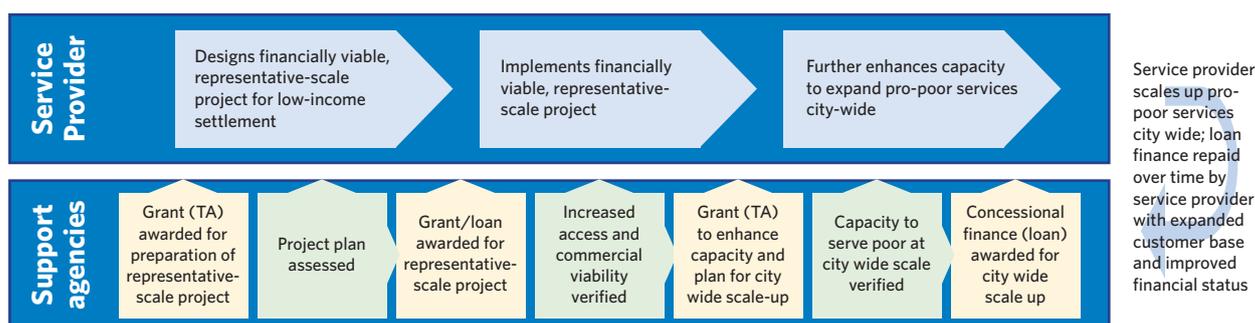
Under the PLF model, international financing institutions (potentially including multilaterals, bilaterals, and foundations) would enter into financing agreements with urban WASH service providers, notably utilities and municipalities. The financing institution would make a commitment to provide concessional finance at a pre-specified time in the future, on condition that the service provider has by that time demonstrated commercially viable service delivery to low-income districts, and has built capacity to a level of readiness for scale-up of services to the urban poor.

In very simple terms, PLF can be summarised as an agreement of the following type: *"If the service provider can demonstrate 3 years from now that they have met conditions A, B and C in relation to financial viability and pro-poor commitment, the financing institution will provide a grant or loan of amount X for WASH scale-up"*. In reality, of course, agreements would likely be substantially more complex (see Figure S1). For example, application of the PLF model could also entail a series of agreements, involving a number of financing institutions providing a range of loans and grants to a number of WASH service providers, in order to reward commercially viable pro-poor service provision iteratively, as it develops.

The 'progress' on which finance thus depends would be agreed clearly in advance, using an appropriate mix of indicators. Service providers would be supported to achieve the required progress, and progress would be rigorously verified by an independent agent.

[continues overleaf]

**Figure S1.**  
What a PLF process might look like: an iterative process of progress and reward.



This report assesses the feasibility of the PLF model and its potential niche within the current urban WASH financing landscape. It finds that, while most of the constituent elements of PLF can be found in existing urban WASH financing approaches, the concept as a whole is differentiated by its combination of the following key aims:

- Increasing access and quality of service to low-income urban settlements in a financially sustainable manner
- Linking finance to demonstrated results and capacity improvements to incentivise reform
- Directly engaging with and supporting the entities mandated to provide services in urban areas, i.e. utilities and municipalities (and, through them, smaller-scale or informal service providers)
- Providing an accessible “route to finance” for such service providers regardless of their initial capacity and financial sustainability

However, this initial assessment of the feasibility of PLF indicates that realising these potential benefits will require careful design and implementation. This is the focus of the main body of this report, which establishes possible options and optimal solutions for the following:

- a) Defining ‘progress’ towards commercially viable services for poor people: who is involved, what is the appropriate process, and what are the possible markers of progress.
- b) Developing structures to link finance to progress: potential institutional architectures for a PLF approach, and for supporting and verifying progress.
- c) Sourcing and spending the finance awarded in return for progress: how the funds attendant on a PLF agreement are to be sourced and disbursed (mix and sequencing of funding), and how they could be used.

<sup>4</sup> OECD. (2011b). Paris Declaration and Accra Agenda for Action

To provide a framework for exploring whether and how PLF can make a positive contribution to the urban WASH financing landscape, the model is evaluated against the five principles of the Paris Declaration on Aid Effectiveness: Ownership, Alignment, Harmonisation, Results, and Mutual Accountability.<sup>4</sup> The report finds that, if appropriately designed, PLF can fit with these principles, so that there are certainly grounds for taking this concept forward and exploring potential application in greater depth. Options include convening a stakeholder meeting to establish interested parties and ways forward, notably through a PLF pilot which could entail: building PLF into a wider urban infrastructure investment programme led by a multilateral development bank (as a dedicated pro-poor component); developing PLF as a shadow mechanism in relation to an existing sector-wide approach; or as a smaller-scale agreement between a bilateral financing institution or foundation, and a medium-sized service provider.

“ A commercially viable pro-poor service delivery model should be defined consensually ”

However, there are also obvious advantages to be gained, in terms of reach and learning, from undertaking a more ambitious pilot involving several locations and service providers. This would also allow the elements of competition to be introduced, whether prior to the PLF agreement being signed (multiple service providers competing to take part on 'challenge fund' principles) or after (multiple service providers competing to achieve the greatest progress, and eventually rewarded with 'bronze', 'silver' or 'gold' levels of financing).

Further recommendations, derived from a desk study and key informant interviews with urban WASH financing experts, are as follows:

#### Key principles for establishing what progress entails include:

- **Consensus and participation:** As far as possible, components of a commercially viable pro-poor service delivery model and the relevant reforms and capacity development needs should be defined consensually between service provider, financing institutions and other bodies as necessary.
- **Taking a realistic approach to commercial viability:** Commercial viability for pro-poor services should be defined in a context-specific manner, with structured subsidies permitted as appropriate, especially for components of WASH services with strong public-good benefits.
- **Integrating small-scale independent providers:** PLF requires recognition and integration of the small-scale independent providers that often fill the service gap in areas not covered by the official provider.
- **Defining who is poor:** Strengthening the service provider's own ability to identify poor unserved potential customers is a first priority of any PLF agreement.
- **Incorporating the full sanitation chain:** Collection, treatment and reuse must be addressed within any pro-poor sanitation business model, requiring involvement from those responsible for drainage and general urban planning, as well as SSIPs.
- **Choosing service levels appropriately:** In addition to cost-effectiveness, health impacts, demand and convenience should influence the selection of appropriate technologies and service levels for a pro-poor, commercially sustainable business model.
- **Designing flexible payment systems:** A pro-poor business model should find solutions that work in situations in which low-income groups struggle to make regular payments, potentially by involving regulated small-scale independent providers.
- **Incentivising throughout the organisation:** Staff-level incentive structures, including bonuses, may be required to stimulate a cultural shift towards viewing pro-poor services as good business sense.
- **Enhancing upward and downward accountability:** Progress conditions and the structure of a PLF agreement should include measures to strengthen accountability between customer and service provider, and between service provider and government.

“ Enforcement of the thresholds for progress should be sufficiently strict to create a meaningful incentive ”

### Possibilities for the institutional and procedural arrangements for a PLF agreement include:

- **Institutionalising PLF within a trust fund:** In the long term, a trust-fund (national, regional or international) is likely to be the natural arrangement in which to house PLF, allowing longer-term financing commitments and navigating individual institutions' restrictive procedures.
- **Enforcement – balancing incentive with practicality:** While enforcement of the thresholds for progress should be sufficiently strict to create a meaningful incentive, some room for negotiation may be a practical necessity for both service providers and financing institutions.
- **Matching support to needs:** A wide range of approaches and mechanisms for assessing and delivering capacity development—including shadow credit ratings, operator partnerships and performance-linked contracts—should be considered in each context.
- **Collecting and verifying performance information through local systems where possible:** PLF should aim to utilise and strengthen local systems for the collection of data, especially those of the service provider, and actively involve users themselves, for example through customer satisfaction surveys.

### Possibilities for sourcing, sequencing and using progress-linked finance include:

- **Taking a flexible approach to funding sources:** While the present study indicates that PLF offers distinct advantages, it will compete in a crowded marketplace with new and established mechanisms and procedures. Proposals for a PLF pilot should cast the net widely across traditional/non-traditional and international/domestic sources of finance, and maximise the synergies between different sources.
- **Using the terms of funding to magnify incentives:** As well as the overall amount of funding involved, the terms on which finance is tied to progress may be used to incentivise further change.
- **Permitting service providers some discretion in how they spend finance awarded at the end of a PLF process:** While the emphasis must be on serving low-income areas, there are arguments for permitting the service provider a degree of discretion in determining how to use a limited portion of the finance attendant on progress.
- **Using PLF to leverage other sources of finance:** An alternative to awarding concessional finance for scale-up at the end of a PLF process may be to use the progress achieved as a platform to seek commercial credit or patient capital, notwithstanding the need to offer sufficiently predictable rewards so as to incentivise service providers.

## Abbreviations

AFD	Agence Française de Développement, France
ADB	Asian Development Bank
AfDB	African Development Bank
AIIISG	All India Institute of Local Self-Government
AMCOW	African Ministers' Council on Water
AusAID	Australian Government Overseas Aid Program
BMGF	Bill and Melinda Gates Foundation
CEPT University	Centre for Environmental Planning and Technology
COD	Cash-on-delivery
DFID	Department for International Development, UK
DGIS	Directoraat Generaal Internationale Samenwerking, Netherlands
DHS	Demographic and Health Survey
EIB	European Investment Bank
EU	European Union
FIPAG	Fundo de Investimento e Património de Abastecimento de Água, Mozambique
FMO	Financierings-Maatschappij voor Ontwikkelingslanden, Netherlands
GIS	Global Information System
GPOBA	Global Partnership on Output Based Aid
IBNET	International Benchmarking Network for Water and Sanitation Utilities
IFC	International Finance Corporation
IFI	International Financing Institution
IMF	International Monetary Fund
IWE	Institute for Water Education
JIRAMA	Jiro sy rano malagasy, Madagascar
JMP	Joint Monitoring Programme
KfW	Kreditanstalt für Wiederaufbau, Germany
KPIs	Key Performance Indicators
MDG	Millennium Development Goal
MICS	Multiple Indicator Cluster Survey
MIS	Management Information System
NCWSC	Nairobi City Water and Sewerage Company
NSP	Non-sovereign Public Sector Financing Facility
ODA	Overseas Development Assistance
OBA	Output-based aid
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
ONAS	Office National de l'Assainissement du Sénégal
PAS	Performance Assessment System
PLF	Progress-Linked Finance
PPIAF	Public-Private Infrastructure Advisory Facility
PRSP	Poverty Reduction Strategy Paper
SAP	Structural Adjustment Program
Sida	Swedish International Development Cooperation Agency
SMART	Specific, Measurable, Achievable, Realistic, Time-bound
SIP	Small-scale independent provider
SWAp	Sector-Wide Approach
TA	Technical Assistance
UMC	Urban Management Centre
UN-HABITAT	United Nations Human Settlements Programme
UNESCO-IHE	UN Educational, Scientific and Cultural Organization: Institute of Water Education
UNICEF	United Nations Children's Fund
USAID	United States Agency for International Development
WASH	Water, Sanitation and Hygiene
WHO	World Health Organization
WSC	Water and Sewerage Company
WSP(AF)	Water and Sanitation Program (Africa Region)
WSPs	Water Service Providers
WSS	Water supply and sanitation
WSTF	Water Services Trust Fund
WSUP	Water and Sanitation for the Urban Poor

## 1. Introduction

### 1.1. The challenge of bringing WASH services to poor urban residents

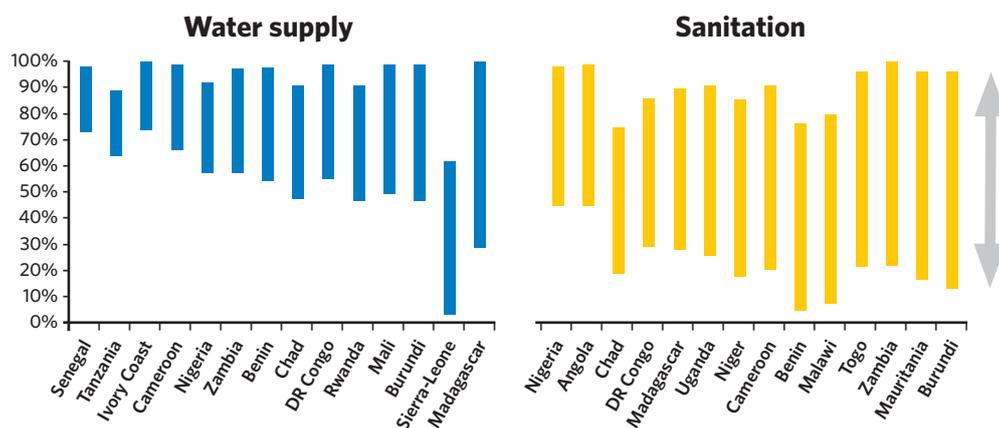
The international community and national governments often determine their progress on water supply and sanitation services relative to Millennium Development Goal 7c:

“Halve, by 2015, the proportion of the population without sustainable access to safe drinking water and basic sanitation” ([www.un.org/millenniumgoals/enviro.n.shtml](http://www.un.org/millenniumgoals/enviro.n.shtml))

Unequal progress between countries is revealed by the statistics produced by the UNICEF and WHO Joint Monitoring Programme. While some countries and regions are on track, others are not (WHO and UNICEF, 2010). But the national-level indicators conceal serious inequities at other levels: above all, between rich and poor.

Figure 1-1 shows the yawning gulf in access to improved water supply and sanitation between the poorest and wealthiest segments of the urban population, for a selection of countries in Africa. At the lower extreme, is the proportion of people in the poorest fifth of the population with access to an improved service; at the upper extreme, the proportion of the wealthiest fifth with access.

**Figure 1-1: Poverty and access - the coverage gap between the poorest fifth (bottom of bars) and richest fifth (top of bars) of the urban population of various African countries.** Source: *Special tabulation, UNICEF Statistics and Monitoring Section, 2010 based on latest (post-2004) MICS or DHS for each country. Countries selected are the 14 with the largest coverage gaps, for water supply and sanitation respectively, for which data is available.*

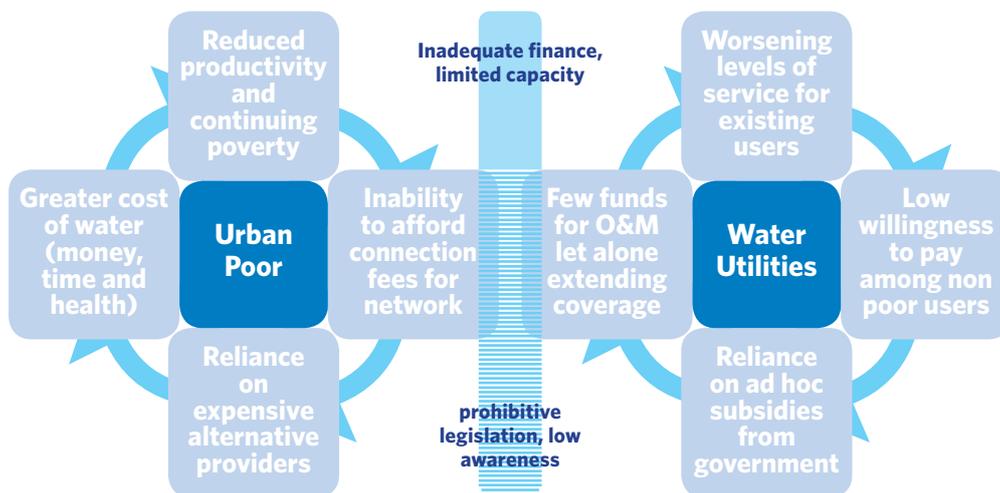


The situation is even more severe if piped water is considered: across Africa, only half of people in the poorest fifth of the urban population have access to piped water; while for the richest fifth the proportion is closer to 90% (UN-HABITAT & WHO, 2010). Access to piped water is a reasonable proxy for the service provided by utilities, as usually only a limited number of officially recognised service providers have the mandate and scale to provide networked water supply. But piped water provided by a utility, properly regulated, is potentially the safest form of access. It also offers considerable time-saving benefits over other forms of improved water supply, such as boreholes. While the initial costs of development are usually higher than ‘simpler’ technologies on a per-capita basis, the cost to the consumer may be many times lower (Hutton & Haller, 2004).

As a result of not having access to piped water, poor urban residents often face far higher unit costs for water provided by alternative, informal providers than their wealthier counterparts who enjoy a connection to the official network (Kjellén & McGranahan, 2006). Despite paying higher costs for their water, poor potential customers cannot connect to the network because the fee to do so may be of the order of several hundred dollars and is frequently demanded as a lump-sum payment – putting it beyond the reach of meagre and sporadic incomes (Komives, Foster, Halpern, & Wodon, 2005). On the utility’s side, there may not be the funds or management capacity to provide more affordable options, or to systematically target poor potential customers. Other barriers can be either written into law – such as prohibition on providing services to informal settlements – or attitudinal – an ingrained suspicion that poor urban residents will not pay for services.

Both poor residents and utilities are therefore trapped in vicious circles, with the potential for a mutually beneficial arrangement blocked by lack of finance, pro-poor management capacity, prohibitive legislation around the rights of tenants and slum dwellers, and low awareness on both sides. On the one hand is the poor household, paying more for lower quality water and service; on the other, the utility, unable to expand its reach to a customer base that could provide enhanced revenue (Figure 1-2).

**Figure 1-2:** Vicious circles preventing poor urban residents from gaining access to water services, and water service providers from expanding their customer base and enhancing revenue. Source: Mason (2009).



In the case of sanitation and hygiene, the nature of the service, and service provider, may be different. While networked sewerage is often provided by a utility, a private connection is enjoyed by only 10-15% of the population of low-income countries in Africa. The remainder, if they do not resort to open defecation, use on-site facilities ranging from bucket latrines to septic tanks, with the fastest growth occurring in traditional latrines which may not effectively segregate human excreta (Morella, Foster, & Banerjee, 2008). All on-site facilities require emptying in dense urban areas where there is no room to simply cap an existing pit and dig another one. But often the task of encouraging households to build latrines and take up safe hygiene behaviours such as hand washing is the responsibility of a government ministry (usually the Ministry of Health), while emptying services are nominally entrusted to the municipal authority or local private sector (*Ibid.*). The sanitation sector in many developing country cities is beset by fragmented responsibilities, inadequate funding and a lack of strategy or even basic policy (AMCOW & WSP, 2011). All of this exacerbates a further set of vicious circles, similar to those depicted in Figure 1 2, but potentially even more complex. Poor urban households are excluded from safe and sustainable sanitation by lack of capital, but also a myriad other factors: landlords that would rather have another bedroom than a latrine; streets too narrow and dilapidated for waste collection trucks; and understaffed, poorly equipped agencies at all levels of government.

Meanwhile the challenge intensifies as urbanisation continues. Without rapid preventative action, including improvements in water, sanitation and hygiene (WASH) services, urban incomers will swell the ranks of slum-dwellers at a rate of an additional 6 million per year. At the same time, there is a simultaneous trend for expansion of satellite towns, and peri-urban areas, which present their own unique challenges (UN-HABITAT, 2010).

Utilities now serve a smaller proportion of the urban population of South and South-East Asia, and Sub-Saharan Africa, than they did in 1990. In the latter two regions increases in sanitation coverage are only just keeping pace with urban population growth (WHO and UNICEF, 2010).

“ PLF places equal emphasis on serving the poor, and doing so in a commercially viable manner ”

Rectifying this, and helping both service providers and poor urban residents to escape their respective vicious circles will cost money. Although access to commercial credit is a worthwhile goal for any service provider, the weak financial position of most entities providing WASH services in developing countries means there remains a need for concessional finance (loans with forgiving terms of interest through to grants). Furthermore, given the constraints on developing country government budgets, overseas development assistance (ODA) and other forms of *international* concessional finance will remain important (OECD, 2010). At the same time, the global financial crisis has intensified pressure on such international finance ('transfers') intensifying, as we shall see, the need to demonstrate value for money and 'results' - see for example DFID's recent aid review (DFID, 2011). Consequently, this report considers how international concessional finance can be routed in smarter ways to achieve financially sustainable WASH services for poor urban residents.

## 1.2. Using finance to leverage change: introducing the Progress-Linked Finance approach

Traditional forms of international concessional finance for WASH interventions have not overcome the above challenges. Conventional concessional finance may have some pro-poor emphasis, but urban infrastructure is often constructed for the 'low-hanging fruit', of wealthier, formal settlements. At the same time, the ability of service providers to provide affordable and sustainable services to poor people cannot be considered in isolation from the commercial viability of the wider business. While significant funds are invested in capacity building and technical assistance, levels of commercial and operational efficiency remain low in many cases - with the result that the sector loses an estimated US\$3bn per year in inefficiencies such as non-revenue water, in sub-Saharan Africa alone (Foster & Briceño-Garmendia, 2010). Meanwhile commercial finance, which might provide the incentive structure both for improved efficiency and extension of services to increase the customer base, remains out of reach due to hurdles including constrained tariff levels, limited capital markets, and overall risk profile of the service providers given widespread under-capitalised balance sheets and lack of bankable projects (OECD, 2010).

This said, increasing the reach, effectiveness and sustainability of services to poor urban residents has of course long been a common goal for sector actors- indeed, the need for continued focus and innovation in this regard was acknowledged by all the experts interviewed for this study. Innovations such as Output-Based Aid (OBA) have sought to create incentives for more pro-poor investments but, as is argued throughout this report, there are constraints to this and other existing modalities and procedures which imply a space for further innovative approaches to help realise the common goal.

This report assesses the feasibility and practical implementation of one such approach, titled Progress-Linked Finance. The concept, developed by Water and Sanitation for the Urban Poor (WSUP), entails pre-agreements between financing institutions and urban water/sanitation service providers whereby the latter are encouraged to develop commercially viable, pro-poor services in return for concessional financing. Two main components are envisaged, with the financing institution committing to fund the service provider on condition that, over a specified period, it develops:

- i) **the institutional capacity to serve the poor** (readiness); and
- ii) **a service delivery model for low income settlements shown to be commercially viable at a representative scale** (demonstration).

PLF therefore places equal emphasis on serving the poor, and doing so in a commercially viable manner. Box 1-1 provides further explanation.

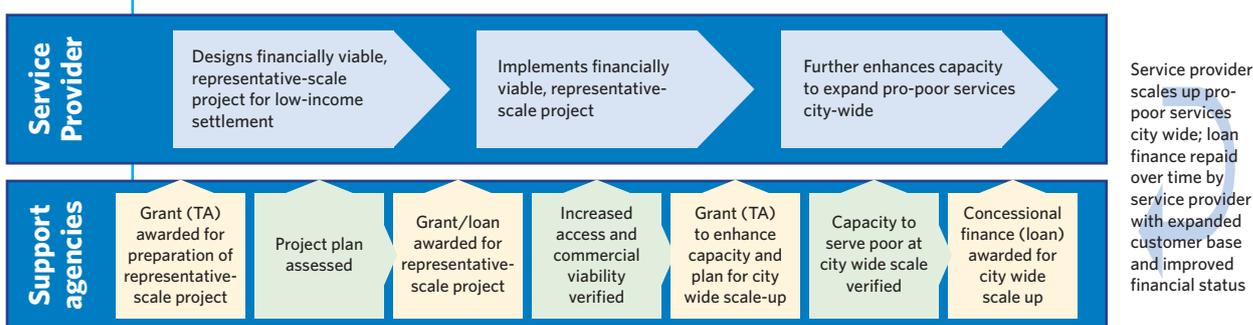
**Box 1-1: A short guide to Progress-Linked Finance**

PLF would usually be agreed between international financing institutions (IFIs, potentially including multilaterals, bilaterals, and foundations) and urban WASH service providers, notably utilities and municipalities. Under a PLF agreement, the IFI would commit to finance only if the service provider is able to demonstrate commercially viable service delivery to a low-income district at a representative scale, and to meet a predetermined series of conditions indicating readiness for scale-up of services to the poor. In simple terms: “If the service provider can demonstrate 3 years from now that they’ve met conditions X, Y and Z, the IFI will provide a grant or loan”.

Based on this simple template, more sophisticated PLF arrangements can be envisaged; for example, an iterative process, with a series of stages agreed, and different levels of grant and loan financing made available on satisfactory progress to each stage.

However many stages are involved, the PLF approach requires tailored support to service providers to help them achieve the envisaged progress, and rigorous independent verification of that progress.

Figure 1-3 shows how one permutation of PLF might be designed and implemented, while later sections of this report explore the various alternatives in greater detail.



*Figure 1-3: How a PLF process might look: iterative progress verification and reward (This figure, already presented in the Summary, is reproduced here for clarity)*

Central to the concept is that it is in the service provider’s commercial interests to serve everyone, not only wealthier urban residents. Progress-Linked Finance (PLF) aims to leverage additional funds by attracting household finance (more revenue from more paying customers) and private finance (increased credit-worthiness stemming from expanded, commercially viable services). At the same time, PLF is based on the rationale that public investments remain absolutely essential, particularly for capital-intensive water networks and the full urban sanitation chain (including faecal sludge management).

Representative scale is defined in this context as “the delivery of service improvements at a scale which is large enough to confirm an approach is effective, viable, and sustainable and can be adopted at city level. It is larger than a traditional NGO project and is context specific based on a range of factors such as population size and density. In a large city this could be 100,000 to 200,000 people, in a secondary town 50,000 to 70,000” (WSUP, 2011a).

PLF can also be understood in normative terms, i.e. what it aims to achieve:

- Increase access and quality of service to low-income urban settlements in a financially sustainable manner
- Link finance to demonstrated results and capacity improvements to incentivise reform
- Directly engage with and support the entities mandated to provide services in urban areas, i.e. utilities and municipalities (and, through them, smaller-scale or informal service providers)
- Provide an accessible finance option for such service providers regardless of their initial capacity and commercial viability

This report was conducted by the Overseas Development Institute (ODI) Water Policy Programme on behalf of WSUP, using desk research and key informant interviews. The methodology is presented in Box 1.2. The next section aims to answer the critical question of whether there is a need for a PLF-type approach, before questions of feasibility and practical implementation can be addressed in following sections. The sections are arranged as follows:

- Rationale - the need for a PLF approach, and its potential place in relation to other concessional WASH financing approaches.
- *Progress-linked finance* - the who, how and what of defining what progress means.
- *Progress-linked finance* - how progress is tied to finance, in terms of the potential institutional architecture and how progress can be verified and supported.
- *Progress-linked finance* - how the funds attendant on a PLF agreement are to be sourced and disbursed (mix and sequencing of funding), and how they could be used.
- Piecing the PLF puzzle together - an overview of issues for PLF design and implementation.
- Conclusions and recommendations - re-evaluating PLF's potential contribution to the development financing landscape, and drawing together recommendations.

### **Box 1-2: A methodology for exploring innovative finance**

The research for this report was divided into two principle phases: desk research and key informant interviews. The research was largely inductive, fitting the nature of the study as a scoping/feasibility exercise for an as-yet untested concept.

The desk research focused on the literature for topics such as urban WASH financing, 'pro-poor' service provision, and aid effectiveness, in order to undertake a preliminary assessment of the feasibility of the PLF approach and its 'fit' within the WASH financing landscape. Following the desk research, a feedback meeting was held with WSUP to refine a preliminary list of questions for WASH financing experts. The questions focused on confirming the feasibility and rationale of the PLF approach, as well as practical design and implementation issues. Two major sets of stakeholders were consulted: service providers and financing institutions (including bilaterals, multilaterals and foundations).

The key informant interviews were undertaken from late May to August 2011. Interviewees were invited to participate based on a purposive sample, which aimed to include a diverse range of actors and opinions, as well as to build on WSUP's existing links. The sample was expanded to include several additional leads as they arose.

## 2. What is the need for a PLF approach?

### 2.1. Situating PLF in the financing landscape

The normative explanation of PLF presented in Box 1-1 (i.e., what PLF aims to achieve) provides a frame of reference to situate the approach within the urban WASH financing 'landscape', and compare it with other international concessional financing procedures and modalities. The financing landscape in question is highly complex and most, if not all, financing institutions have evolved their own procedures. Consequently the broad classes of financing approach referred to here should not be taken to capture every possible variation.

#### Focus on improved, financially sustainable services for low-income settlements

Much of the concessional urban WASH financing landscape is still constituted by 'project approaches', a particularly general label but which has been defined as those "which fund discrete sets of activities with discrete objectives" (Williamson & Dom, 2010). A project approach does not necessarily imply smaller scale, since the major multilateral development banks<sup>5</sup> refer to many of their operations, including substantial city-wide infrastructure investments, as "projects". In such cases, funds may be provided as loans and credits or grants: for example, the Asian Development Bank (ADB) provides both through its Asian Development Fund (Asian Development Bank, 2011). At the same time, the project approach is often associated with relatively smaller activities (in terms of size of funds and number of beneficiaries) undertaken by NGOs and bilateral finance institutions, more often on a grant basis.

As implied in the definition quoted above, one appeal of the project approach for financing institutions is that it permits the funder considerable discretion over how, and on whom, funds are spent. In this respect project approaches may claim to be 'pro-poor' (see Box 2 1). This claim may be made in terms of the intended beneficiaries - for example, an urban infrastructure upgrading project which uses geographical targeting to increase the number of low-income people with access. But project-based finance may also seek to leverage wider pro-poor change, by making funding conditional on certain actions and reforms to enhance the recipient's own capacity to provide for poor people, and thus obtain reach beyond the immediate beneficiaries.

Making funding conditional on certain reforms or actions is contentious, largely because of the legacy of ideologically driven conditionality which required countries to undertake major macro-economic reforms in return for World Bank and International Monetary Fund (IMF) finance under Structural Adjustment Programs (SAPs) - an example from the WASH sector being a requirement for utility privatisation (ActionAid, 2004). The debate continues over how far such conditionality is still embedded within the Poverty Reduction Strategy Papers (PRSPs) which succeeded SAPs over a decade ago, and which countries must prepare as a precursor to World Bank/ IMF finance and debt relief - see for example a critique from Bretton Woods Project (2003) and the World Bank's good practice principles for conditionality (World Bank, 2006). PRSPs are associated foremost with finance which is *not* delivered using project approaches, but rather budget support or programmatic finance - 'development policy operations' in the Bank's parlance (World Bank, 2010). Nonetheless, conditions, whether aligned with the same macroeconomic reform agenda as PRSPs or more project-specific goals, do appear in World Bank project documents - as well as those of other financing institutions. Often they are somewhat masked with semantics, being referred to with terms like 'covenants' and 'milestones'. Acknowledging that PLF is an inherently conditional approach, this report does not shy away from the term, but rather attempts to contribute to and further stimulate the ongoing debate on how conditions can be made genuinely pro-poor.

<sup>5</sup> i.e. the World Bank, the Asian Development Bank, the African Development Bank, the Inter-American Development Bank and the European Investment Bank.

**Box 2-1: What do we mean by pro-poor services?**

The label 'pro-poor' is often used to indicate ambitions of improving equity and benefiting lower income individuals and households, but there are important questions around how poor people are identified and how benefits accrue to them, which are often overlooked in using the term.

First, any activity claiming to be pro-poor needs to define and identify who is 'poor'. This can be surprisingly difficult, especially in some towns and cities where there are no very distinct low-income districts. Even where such areas exist, the spread of incomes as well as the average income can differ significantly between them, while establishing incomes is difficult where a large proportion is derived informally and intermittently. These challenges can make geographical targeting, where everyone living within a certain area is classified as poor and is eligible to benefit from a 'pro-poor' activity, somewhat inaccurate – including non-poor residents ('error of inclusion') or excluding poor residents ('error of exclusion').

In the case of services such as WASH, it may be possible to use the technology itself to identify who is poor, on the assumption that, if subsidised but less convenient service levels are offered (for example tap-stands or yard-taps rather than household connections), poor residents will choose to use them – though it is necessary to point out that many of the benefits of improved water supply and sanitation relate to convenience (time-savings) in the first place (Hutton & Haller, 2004). Self-selection also occurs where potential beneficiaries must apply to be included in the pro-poor activity. More sophisticated methods for distinguishing who is poor generally fall under the label of means-testing and can be very effective but carry higher costs. In analysing how various targeting methods provide benefits to poor people Komives et al. (2005) point to the strengths of different methods in different contexts – e.g. geographical targeting where poor and non-poor live in relatively distinct areas; some form of (proxy) means-testing where cost effectiveness can be enhanced by combining with other subsidised basic and social services. Overall, it is likely that a service provider entering a PLF agreement would need to employ a combination of methods.

As well as distinguishing poor and non-poor, a pro-poor activity needs to demonstrate that the benefits accrue to those intended (poor) beneficiaries. One way to look at this is to make a distinction between relative and absolute definitions of pro-poor. On an absolute definition, if the activity benefits poor people, for example by increasing the number of poor urban residents with sustainable access to safe sanitation, then it can be called pro-poor regardless of how many non-poor residents benefit: in Figure 11, this would mean the bars could get still larger. On a relative definition, those identified as poor need to benefit in greater numbers, relative to the number of non-poor people benefiting (World Bank, 2011a). Another way to look at the issue is to consider the degree to which errors of inclusion and errors of exclusion are acceptable within a definition of pro-poor. Errors of inclusion still have revenue generating potential – customers are customers, whether defined as poor or not – but in ethical terms an activity which provides benefits to large numbers of those identified as non-poor is difficult to term pro-poor.

The need for a robust definition of who is poor and what constitutes a pro-poor service continues given the tendency for funders and implementers to focus on those towards the middle, rather than the very bottom, of the poverty spectrum – it is the latter which PLF, ultimately, needs to benefit above all. At the same time, poverty is difficult to define objectively, and on an international definition, most of those living in developing country cities would be called poor. Some benefits accruing to the so-called non-poor may be inevitable collateral for any pro-poor approach, including PLF.

## “ Reaching the poor on a sustainable basis is a specialist discipline ”

While finance for basic services provided under a project approach may include conditions designed to increase the likelihood of reaching the poor, more often such conditions focus on financial sustainability. For example, the World Bank's Niger Urban Water and Sanitation Project incorporates time-bound requirements relating to recruitment of key personnel, adoption of asset management and accounting software, and restoration of financial equilibrium through application of an agreed tariff policy (World Bank, 2011b). As emphasised in the PLF concept itself (Section 1.2) reforms which aid financial sustainability are a critical part of helping service providers to reach the poor, since without achieving at least operational cost recovery, even fully subsidised network expansion will be loss-making over time. Furthermore, tariff reform can enhance affordability of services as much as the financial sustainability of the provider. However, it is not clear that such reforms get to the heart of what makes an emphatically pro-poor service provider (by no means an easy thing to establish, as discussed in Section 3.2). Reaching the poor on a sustainable basis is a specialist discipline and generally requires a marketing and service delivery approach that is tailored to this market segment – project conditions generally reflect a lack of structured mechanisms or approaches for how to achieve and report against this objective.

The procedural rules which govern the design of conventional investment projects from multilateral development banks may also inhibit a focus on genuinely pro-poor measures. Discussion with government and service providers tends to be front-loaded towards the planning stage, with limited support and supervision during implementation. Follow-up during implementation (especially around the complex matter of serving poor people) may be viewed as an unnecessary complication, jeopardising the principal internal objective of getting loans approved, with acceptable collateral arrangements in place. The front-loaded discussion and support may itself avoid the issue of service delivery solutions for the low-income market, because these can be hard to pre-plan (hence the emphasis of iterative agreements and demonstration of effective service delivery models within PLF). As a result, there may be a tendency for the financing institution to leave it to the government/ service provider to determine whom to serve and how to do so.

This shift of responsibility to service provider or government may, of course, be viewed as positive: the major trends in development finance in recent years have indicated a desire to entrust ownership of the reform agenda to the recipient, which donor-driven conditionality is perceived to undermine. Budget support (general or sectoral) theoretically allows the recipient to spend funds as it sees fit – including the extent to which spending is specifically pro-poor. However, in practice, financing institutions retain a considerable degree of control, exercised through 'soft' influence on development plans and budget design, and through more-or-less explicit conditionality enshrined within a 'performance assessment framework' or 'policy matrix' (Tavakoli & Smith, 2011). At the furthest extreme cash-on-delivery requires the funder to simply offer funds for outcomes and relinquish all control for how those outcomes are achieved. Proponents argue that this stimulates the responsibility and authority of the recipient and reduces administrative costs (Birdsall, Mahgoub, & Savedoff, 2010).

The rationale for increased ownership is that recipient governments and service providers are best placed to determine how to benefit their citizens. But it is also important to recognise that ownership of the project by the service provider does not guarantee financially sustainable pro-poor outcomes, given they face many other urgent priorities and may have many larger projects which the capacity is already in place to deliver. This points to a need for a nuanced understanding of ownership and conditionality, where the two are not treated as mutually exclusive. In the case of PLF, this is very much a question of how conditions are defined and who is involved – a question addressed further in Section 2.

“Results-based approaches risk undermining the less tangible changes which underpin sustained outcomes”

As mentioned, a dedicated focus on bringing sustainable services to poor urban residents in a financially sustainable manner is certainly not an original feature of PLF, and is shared, at least in rhetoric, by almost all financing institutions and, increasingly, service providers. But it is the extent to which a ‘pro-poor’ focus is prioritised and realised in practice which is key. The desk research and interviews undertaken for this study indicate that, whatever the ambitions of the parties involved, there is room for financing approaches which place a more dedicated and explicit emphasis on meeting the needs of urban poor residents.

### **Linking finance to demonstrated results and capacity improvements**

Cash-on-delivery (COD) is one of the latest in a number of innovations that fall under the label of ‘results-based financing’ – a label which could arguably be applied to aspects of PLF. The most established results-based financing approach applied to WASH is output-based aid (OBA), which makes payment conditional on “the delivery of specific services or ‘outputs’ to poor people – i.e. funds are only paid when the intended beneficiaries are receiving a verified service (GPOBA, 2009b). OBA is thus highly conditional (finance dependent on performance) but the emphasis of conditions is transferred from reform processes to the outputs themselves. Developing wider capacity for commercially viable pro-poor services is not ignored, but rather the assumption is that the service provider will have to develop this capacity if it is to achieve the intended outputs. In practice, OBA is often accompanied by extensive technical assistance which may allow the financing institution to shape the development of capacity (GPOBA, 2009a). COD does away with this and emphasises entrusting the method by which outputs/ outcomes are achieved to the recipient.

Results-based approaches can be argued to offer enhanced value for the financing institution, both in a financial sense and a political sense, given the need to justify aid spending to a domestic audience. However, critics perceive the latter to be the principle motivation for the re-emergent “results agenda”, and argue that political value and value-for-money should not be equated. Results-based approaches may give easily countable numbers to justify aid allocations, but they risk undermining the sound relationships and less tangible changes which underpin sustained outcomes (Eyben, 2011).

The PLF concept is arguably more similar to OBA than COD: a close relationship is envisaged between financing institution and recipient throughout the process, with extensive support for achieving the agreed reforms. Whether this support is viewed positively or as micro-management (Green, 2011) is to some extent subjective. It is certainly worth bearing in mind that technical-assistance is rarely purely ‘technical’ and, just as in the design of conditions, it is critical to have an open and accountable relationship between financing institution, service provider, and any other parties involved. However, the reason for a close relationship throughout the implementation phase of PLF stems not from a desire to impose a particular preconceived approach to achieving financially sustainable pro-poor services, but a recognition that both service providers and financing institutions need to work together to understand and test what sustainable pro-poor capacity actually looks like.

PLF is also different from ‘pure’ OBA in very important respects: PLF does not only measure and reward intermediate outputs (demonstrated, commercially viable service to a representative-scale, low-income settlement), but also process (readiness, in terms of capacity to provide sustainable pro-poor services). As is made clear below, this means a far greater range of service providers is potentially eligible, at different stages of development towards being independent, commercially viable entities.

This said, there is certainly much to learn from OBA, as there is from COD – for example the institutional setup of the Global Partnership on Output-Based Aid (GPOBA), or the ‘bonus’ concept applied in COD (Section 4.1 and 5.1).

“ There is a limited number of concessional finance options directly accessible by service providers ”

### Direct engagement with the service provider

Project-based finance may also be made directly available to entities below the level of national government ('sub-sovereign'), such as utilities and municipalities – in common with the proposed PLF approach which views the mandated service provider as the institution best placed to lead on urban WASH service delivery at scale. The GPOBA is open to applications from public and private infrastructure operators, NGOs and local governments, as well as national governments (GPOBA, 2011a).

Concessional loans arranged directly with non-national entities may be prohibited due to perceptions of risk. On the one hand the national government may, as the lender of last resort, be concerned about uncontrolled increases in the national debt (OECD, 2010). On the other hand, the financing institution may be sceptical of a sub-sovereign service provider's financial position, a problem exacerbated by the lack of transparent credit ratings for such entities. Conventionally, a guarantee from national government would be required to mitigate perceived risks, but several financing institutions are now developing alternatives.

The ADB's Non Sovereign Public Sector Financing (NSP) Facility has piloted loans and guarantees for public sector entities providing public goods and services, without requiring central government guarantees. The ADB assumes the credit risk, which it attempts to minimise by careful use of vetting procedures and due diligence (Asian Development Bank, 2007).

These and other methods would need to be considered in the application of PLF, but indicate that there is no *de facto* prohibition on sub-sovereign finance. At the same time, it is still the case that there is a relatively limited number of concessional finance options directly accessible by service providers without government guarantees (OECD, 2010). PLF could contribute to bridging that gap, with attendant benefits of increasing service provider management capacity and autonomy, and helping to build fiscal discipline which could ultimately enable access to commercial finance.

It should be noted that the possibility for direct engagement with the service provider does not mean that this needs to be the hallmark of every PLF agreement. For example where pro-poor policy and legislative reform is required at national level before interventions at city level can be effective, PLF could be allocated to the service provider, within a broader project (perhaps for general urban upgrading) arranged with the government ministries that have the power to leverage the required reform.

### Providing finance to service providers at different stages of development

In the case of grants, perceived risk may also be a prohibiting factor, but in a political rather than financial sense: the risk that results may not be achieved, rather than that money might not be repaid. The GPOBA argues that OBA mitigates this "performance risk" for the financing institution, by transferring it onto the service provider: if results are not achieved, then finance will not be paid.

But because service providers must usually assume the entirety of this risk by pre-financing activities (for example extending the network and connecting people in low-income areas), access is restricted to those service providers with relatively strong financial positions – either sufficient working capital, or the ability to obtain a loan from another source, usually a commercial bank (Kumar, Lieberman, & Mumssen, 2010).

PLF, therefore, is further distinct from OBA because it does not require substantial pre-financing. Progress-Linked Finance is generally provided *before* implementation but *after* verification that a pre-specified state of readiness has been reached – especially in the case of the larger amounts involved in scaling-up commercially viable

pro-poor services city-wide (see Figure 1-3). At the same time, PLF might leave the option open for stronger service providers to pre-finance the initial demonstration of representative-scale, commercially viable services to poor customers.

It should be noted that the GPOBA, as the principle provider of output-based aid, acknowledges the pre-financing problem and is working to develop solutions (Kumar, Lieberman, & Mumssen, 2010). The potential for a PLF approach to be integrated into OBA for this purpose is explored later in this report (Section 5.2).

## 2.2. Does PLF have a distinct niche?

The preceding sections offer a rapid assessment of the advantages and disadvantages of the currently available concessional financing options for urban WASH in developing countries. It should be emphasised that the scope of the assessment is necessarily limited. For example, a comprehensive review of conditions attached to WASH finance was not possible, and there may be projects which are experimenting with the dedicated emphasis on commercially viable pro-poor services envisaged under a PLF approach, that were not picked up on.

Nonetheless, experts consulted in the course of research indicated that while use of conditions is widespread in project approaches, and may include pro-poor aspects, a dedicated and explicit emphasis on enhanced pro-poor capacity (with financial sustainability as a necessary corollary) is rare, and does not appear to be currently applied in a systematic fashion. Furthermore, approaches that are directly accessible by a wide range of service providers themselves are also limited – many service providers in sub-Saharan Africa and South Asia, for example, would struggle to attract either conventional project finance or OBA from a financing institution. Table 2-1 summarises the niche PLF could potentially fill.

**Table 2-1: PLF characteristics in relation to other major financing modalities.**

	(Sector) Budget support	Project aid	Cash-on-delivery	Output-based aid	Progress-linked finance
Explicit focus on commercially viable pro-poor services	x	✓	x	✓	✓
Demonstration required to trigger finance	x	x	✓	✓	✓
Directly accessible by service providers	x	✓	x	✓	✓
Does not require pre-financing by service provider	✓	✓	x	x	✓

Source: Authors' own.

Consequently, the conclusion of this section is that there is sufficient need for a PLF type approach to merit further exploration of the practical issues of design and implementation. An apparent niche does not, however, mean that PLF would necessarily make a positive contribution to the WASH financing landscape, and much depends on the details discussed in the following sections, with reference to expert opinion and further insights from the desk study.

Before embarking on this detailed discussion, it may be helpful to refer to a set of principles which have received, to a large extent, endorsement across the development community: the Paris Declaration on Aid Effectiveness (2005). While the relative importance of these principles continues to be debated at high level fora, including Accra (2008) and Busan (2011) (OECD, 2011a), they remain the principal internationally acknowledged framework for international concessional finance. Table 2-2 presents these principles, and notes the extent to which they pose an issue for PLF.

These principles are referred to throughout the sections which follow. They are returned to in Section 7 to re-evaluate if and how, in the light of the analysis presented in the report, PLF can be designed and implemented to make a positive contribution to the WASH financing landscape.

### 3. The P in PLF: Progress

As implied in the above discussion of conditionality (Section 2.1), the manner in which conditions are defined and the parties involved is of critical importance. In the case of PLF, defining conditions is essentially a matter of defining progress - what constitutes i) capacity for sustainable pro-poor service provision and ii) demonstrated, financially-viable service to a low-income area at representative scale.

This gets to the heart of an inherent tension between two of the aid effectiveness principles listed in Table 2-2: results and ownership. On the one hand, the financing institution's requirement for evidence that its development spending and interventions achieve their desired effects may encourage it to define conditions/ progress unilaterally. On the other hand this can only serve to undermine developing countries' ownership of their own development agenda - a goal which, as the recent Evaluation of the Paris Declaration points out, has seen reasonable progress (Wood, et al., 2011). This was noted by several of the WASH financing experts interviewed. At the same time it was broadly acknowledged that, where the conditions are agreed in a transparent, consensual manner to enhance pro-poor service provision, as well as financial sustainability, this tension can be managed.

However, before the specifics of such conditions and the process for agreeing them can be explored, it is necessary to introduce the various prospective parties to a PLF agreement, and their constraints and interests.

**Table 2-2: PLF and the Paris Principles on Aid Effectiveness.** Source for the five fundamental principles of the Paris Declaration on Aid Effectiveness: OECD (2011b).

Paris Principle	Issues for PLF design and implementation
Ownership: Developing countries set their own strategies for poverty reduction, improve their institutions and tackle corruption.	As mentioned, financing approaches which involve conditionality can be perceived as undermining ownership, especially if those conditions are perceived to arise from a donor-driven agenda which is rooted more in ideology (e.g. neoliberal economics) than positive outcomes for people in the country concerned.
Alignment: Donor countries align behind these objectives and use local systems.	PLF, with its goal of sustainable pro-poor WASH services, is likely to be broadly aligned with national development goals. However, in relation to using local systems, PLF may initially be perceived as a project-based approach with its own set of procedures and implementation requirements necessitating a parallel implementation structure, or at least dedicated supervisory staff in the field.
Harmonisation: Donor countries coordinate, simplify procedures and share information to avoid duplication.	The extent to which PLF could aid harmonisation between donors depends to some extent on the level of buy-in, and whether it is designed and implemented to complement any existing efforts to increase pro-poor services in the urban area in question.
Results: Developing countries and donors shift focus to development results and results get measured.	PLF is arguably in part a results-based approach, insofar as it requires a demonstration of sustainable pro-poor services at representative scale, and capacity to scale those services up. In this sense, the principle of Results may be the easiest 'sell' for PLF - not only for donors but also for recipient service providers and governments given the potential for PLF to strengthen their own information systems. But while PLF is distinct, for example in being potentially available to a range of service providers at different stages of financial development, it is important to be aware that it would compete in a crowded marketplace for donor support with approaches such as COD and OBA, which focus further down the causal chain (outputs) and are thus more clearly results-focused.
Mutual accountability: Donors and partners are accountable for development results.	The ostensible emphasis of the PLF agreement is on holding the service provider accountable for its results, with the success or failure of the PLF process resting on its effort, rather than the mutual effort of all partners. It might be argued that this creates an unequal relationship with the financing institution, which is not being held accountable in the same way for potential failure to achieve progress.

“Utilities are of course a heterogeneous set of entities”

### 3.1. Who is involved? Parties to a PLF agreement

As mentioned, PLF is intended to permit the possibility that agreements can be made directly between service providers and financing institutions. The type of service provider may vary depending on the specific WASH service being provided – in most but not all cases, it is envisaged that a PLF agreement would be made with the official service provider for the urban area.

In the case of water supply, the designated official service provider is usually a utility – which may be a public or private entity. Responsibility for operations and/or management may be separated from asset ownership, whether this is vested in a government ministry or separate body, as in countries such as Mozambique (World Bank & PPIAF, 2009). Regulatory responsibility may lie with a further agency, or be retained by the ministry. Meanwhile operation and/or management of the services themselves may be delegated (or re-delegated) by the official utility, or the government, to smaller service providers in discrete service areas or smaller conurbations – as for example in Naivasha, Kenya, where a small private network operator has agreed with the official provider, Naivawass, to manage and operate kiosks in low-income areas (WSUP, 2011b).

Despite the multiplicity of actors involved in urban water supply services, the architecture is usually considerably clearer than that for sanitation and hygiene, where institutional complexity is a long-recognised barrier to pro-poor sanitation investments (WSP, 2011). Indeed, the challenge faced by this study in identifying appropriate representatives of sanitation service providers, with the necessary responsibility and expertise, is indicative of the blurred responsibilities and limited capacity within the urban sanitation sub-sector. The paragraphs below therefore consider separately the particular features of utilities and municipalities, as well as those of financing institutions and other actors such as small-scale independent providers and regulators, which should be taken into account in any PLF agreement.

In a similar manner, the analysis below distinguishes between various different types of financing institution, as well as the institutions which are not directly part of the agreement, but whose interests need to be considered within the overall political economy of financially sustainable pro-poor service provision.

#### Utilities

Utilities are of course a heterogeneous set of entities, and PLF design needs to be cognisant of these differences. The extent to which roles – for management, operation, asset ownership etc. – have been separated out is a first, critical consideration. Given PLF is designed primarily to reward progress in sustainable pro-poor service provision with investment finance, a context in which the utility itself is not responsible for financing infrastructure may appear to prohibit its application. But the case of Mozambique shows how this is not necessarily the case (Box 3-1).

A further important variation between utilities pointed to by experts interviewed is their operating principles. This is more than a simple distinction between public and private, due not only to the various public-private partnership arrangements, but also to the widespread emphasis on commercial operating principles for public utilities – including clear goals for service delivery, autonomous management, results accountability and financial sustainability (World Bank, 1994). The GPOBA stipulates “operating on commercial principles” as an eligibility requirement for public service providers (GPOBA, 2009a, p. 3). Interviewees pointed out that financial sustainability is essential if each new connection is not to increase any existing hole in a utility’s balance sheets. But at the same time, it is important not to equate financial sustainability with recovering all costs from user tariffs and fees alone (OECD, 2009).

**Box 3-1: Fitting PLF into a delegated operations and management context  
- the case of Mozambique**

In Mozambique, the asset holder *Fundo de Investimento e Património de Abastecimento de Água* (FIPAG) is responsible for financing capital works, and thus would be the likely recipient of any Progress-Linked Finance. At the same time, the various utilities (Aguas de Moçambique - AdeM - and others) are responsible for designing, tendering, and supervising capital works programmes, as well as operating the networks. The contractual arrangements between FIPAG and the utilities were hitherto designed to incentivise connections regardless of whether they were for poor or non-poor customers - which achieved limited results in terms of pro-poor infrastructure expansion (World Bank & PPIAF, 2009). However, output-based arrangements have subsequently been introduced (GPOBA, 2011b), providing stronger incentives to specifically increase coverage among poor customers, with promising results according to experts interviewed.

This points to the importance of the contractual incentives and obligations in situations where responsibility for operations/ and or management has been split off from asset ownership. While investment finance would need to be routed through the asset holder in countries such as Mozambique, there is no fundamental obstacle to the asset holder itself requiring the utility to demonstrate that it can design and sustain pro-poor services on a representative scale, as per the PLF concept. Similarly, the asset holder (or regulator, if applicable) might look to incentivise improvements in the utility's capacity to reach poor customers, by increasing the 'pro-poor' emphasis in the range of key-performance indicators (KPIs) which normally underpin delegated management contracts, and govern incentives and sanctions for the utilities. Overall then, delegation of operations and management responsibilities need not preclude PLF, but in such cases the asset holder would need to be fully involved in the arrangement, and capacitated accordingly, alongside the utilities.

In this spirit, interviews pointed to the need to differentiate between utilities at different stages of financial independence, and tailor PLF accordingly. It has already been mentioned that PLF is partially a response to the difficulty faced by many developing country service providers in accessing conventional OBA, because they are unable to pre-finance investments from their own revenues and commercial loans. Consequently, in order to ensure the availability of PLF to service providers regardless of their current level of commercial viability, 'commercial principles' should be carefully defined: its meaning here is more akin to achieving increasing levels of cost recovery from user fees and tariffs (within the bounds of affordability and subsidised with concessional public finance as necessary), than recovering all costs from users. Similarly, in the context of PLF 'commercial principles' might be regarded as a goal for utilities, rather than a pre-condition, with the development of such principles included as part of the required progress.

All experts pointed to the need to understand service providers' own interests in designing and packaging PLF. Several experts, from both financing institutions and service providers, emphasised that conditions would not necessarily be regarded as an imposition, provided the reasoning behind them was made clear. Rather than packaging PLF in terms of the ethical goal of serving poor people, or the immediate financial incentive of finance for infrastructure, it was suggested that a major attraction for utilities would be the prospect of PLF enhancing long-term financial sustainability. This could be achieved both through the associated technical assistance (if, for example, it included support to reduce non-revenue water), and through the increased revenue associated with an expanded, commercially viable service area. It was further suggested that utilities may see the clear framework for reform and reward under a PLF agreement, as a useful basis for negotiating further, domestic finance from their own ministries.

“ It is important not to equate financial sustainability with recovering all costs from user tariffs ”

The predictability of finance was also noted as a key concern from utilities' perspective – especially for infrastructure investments where construction may be undertaken by contractors, who must be promptly paid. Consequently it was suggested that Progress-Linked Finance need not be exclusively conditional. While some funds could be offered on condition of increasing capacity for sustainable pro-poor services, and demonstrating commercially viable pro-poor service provision, others could be offered on a non-conditional (or less conditional) basis – essentially as a pro-poor 'bonus'. The logical possibility, mentioned above, to utilise PLF as a component within a broader urban infrastructure project employing mainly traditional concessional finance, could have a similar effect.

Respondents also emphasised that within the service provider, it may be possible to identify particular individuals to spearhead or pilot a PLF arrangement: for example young managers of utility outstations in secondary towns who might have the advantage both of a relatively defined service area, and career ambition. In a similar vein, one respondent emphasised that while the problem of political appointments to management positions continues in some utilities, it should be possible to identify pro-active and capable individuals or cadres.

### Municipalities

As mentioned, this study was unable to consult sanitation experts within municipalities themselves – a symptom of the institutional confusion and limited capacity afflicting urban sanitation. Indeed, one expert from a financing institution went so far as to question whether it would be more sensible to entrust responsibility for all sanitation services – both networked and onsite – to utilities who could then sub-contract as required. Other respondents emphasised the need to consider the entire sanitation chain, and the place of sanitation within overall urban planning (see Section 4.1), which would require engagement beyond either municipalities or utilities. The macro reforms and strategies required point to the need to engage multiple parties, rather than the nominally responsible institution alone. The experience of one interviewed expert in engaging across multiple urban sectors was that this is easier to accomplish when working through national-level institutions such as ministries, rather than attempting to convene multiple sub-sovereign entities. The European Investment Bank (EIB) has had some success engaging small towns in Ghana, with the national-level Community Water and Sanitation Agency playing an important intermediary role given constrained financial and institutional sustainability in the towns themselves.

In Senegal, where responsibility is vested at national level, rather than municipal level, a performance contract has been signed between the *Office National de l'Assainissement du Sénégal* (ONAS) and the government, requiring the latter to cover the financing gap if ONAS achieves performance indicators relating to, among others, new on-site and networked sanitation facilities, and financial management (WSP, 2011). The Senegal example also indicates that even in countries with a relatively successful arrangement for urban sanitation, there is a clear expectation that public subsidy (properly managed) is required – given the public good characteristics of a sanitary environment. This may make it especially important to properly define any expectation of commercial operating principles (particularly cost recovery) in the case of sanitation – as discussed above in relation to utilities. In so doing it would likely also be necessary to make a clear distinction between the differing levels of public good and cost recovery potential inherent in different technologies and components of the sanitation chain, e.g. onsite sanitation, faecal sludge management, or sewerage.

Where it is not possible to engage with an existing national-level entity, but municipalities remain the designated lead institutions for urban sanitation, PLF must be adapted as necessary. One suggestion was to work through a local NGO with understanding of the local political context, and how the municipality can work together with small-scale independent providers and other actors.

“ A PLF agreement with an official service provider could require engagement with SSIPs ”

### Small-scale independent providers

Beside the officially designated service providers, small-scale independent providers (SSIPs) are a special class of actor that require particular attention in the context of PLF, because of their increasingly acknowledged role in bridging the service gap (UNDP, 2011). Although more heterogeneous even than official service providers – in their scale, business model and service quality – they are likely to be found operating in parallel in any given service area where PLF could potentially be used. While the PLF approach rests on the argument that the safest, most affordable WASH services are provided by a properly regulated official provider operating at scale, SSIPs remain critical in the short to medium term, and potentially in the long-term, offering the flexibility and ancillary services which utilities and municipalities have traditionally struggled to provide. While it may not be possible to create individual PLF contracts with a multitude of SSIPs, a PLF agreement with an official service provider could require structured engagement with SSIPs operating within the service area, in turn enabling investment flows to such providers and involving them as subcontractors for services such as kiosk management, latrine construction and pit emptying.

Furthermore, while in most cases a PLF agreement would be made with the official provider, with SSIPs reached through sub-agreements, there may be instances where the principal agreement is made directly with a smaller entity: for example, where medium-sized entities have stepped in to fill the service gap in informal or peri-urban settlements, because they are not within the official provider’s mandated service area, or are being otherwise overlooked. Interviews pointed to the need to make clear the incentives for both sides, given that both official and small-scale independent providers could resist one another’s incursion into their perceived service area.

### Other domestic actors

Most interviews pointed to the need to understand the broader institutional structure for the sector, and to look beyond the service provider(s) and financing institution(s) at the heart of PLF agreements. An important question for PLF is how it can be designed to strengthen accountability – not only in the sense of the Paris Declaration, of mutual accountability between donor and recipient, but also in the domestic context, between service provider, government, and customers, both potential and existing (World Bank, 2004).

Several interviewees pointed to the critical role for regulation. One potential hurdle identified is where tariff increases are restrained for political reasons, rather than genuine affordability constraints. In such cases the consequent dependence of the service provider on public subsidies may permit government to obtain a controlling stake and make political appointments to the board, reducing managerial autonomy. The case of Mozambique was provided to argue that, where all sides have access to the necessary information and agree reforms in an open and consultative fashion, such political resistance to tariff reform can be overcome (even if it re-emerges during election years). On the other hand, it was argued that for countries such as Zambia, where tariffs have already seen significant increases (Dagdaviren, 2008) the critical concern is increasing operational efficiency rather than raising tariffs further. In either case, a properly designed PLF arrangement could play a part in providing the necessary incentives for government, regulator (if separate) and service provider to leverage change – but once again, these different cases point to the need to adapt PLF to context.

## Financing institutions

A major focus of discussion with experts from financing institutions was the extent to which aspects of the PLF approach were already being used, and the potential fit with broader policies and procedures. As such, it quickly became apparent that multilateral financing institutions – primarily development banks – would have potentially different roles from bilateral donors and other financing institutions such as foundations.

Nonetheless, before turning to these different cases, the special arrangements for engaging with sub-sovereign service providers should be further explored, as this is likely to play a part in most PLF agreements (see Section 2.1) regardless of the type of financing institution involved. As mentioned, the Asian Development Bank has piloted an approach to sub-sovereign financing whereby the lender assumes the risk, which it attempts to moderate through application of due diligence. The European Bank for Reconstruction and Development attempts to mitigate risk by arranging security directly with the service provider, for example a legally binding commitment to a pre-specified tariff increase, or a proviso that the lender can intercept transfers to the service provider from higher levels of government. A hybrid approach is followed by the *Agence Française de Développement* (AFD) for the financing it offers various utilities in Senegal, Cameroon and Cambodia (OECD, 2010). It should be noted that PLF offers potential risk mitigation, whether in the case of grants (where the risk is primarily one of ‘performance’, i.e. failure to achieve results) or of loans (where the risk is also a ‘financial’ one, i.e. risk of default). In the case of loans, because ‘progress’ is defined not only in terms of pro-poor service provision but also enhanced financial sustainability, PLF incentivises service providers to increase their capacity to repay; meanwhile by tying finance to a mixture of output and progress indicators, PLF is designed to ensure the intended pro-poor results of both grants and loans are achieved.

**Bilaterals:** experts from the bilateral financing institutions consulted were generally of the opinion that they were best placed to offer technical assistance and/or play a convening role for other donors (as DFID did in the initiation of GPOBA). Certain aspects of the PLF concept were viewed as being of particular interest, including its focus on sub-sovereign entities and SSIPs. Bilateral financing institutions generally pointed to multilateral development banks as the likely providers of finance for major infrastructure investments.

**Multilaterals:** Bringing in multilaterals, particularly development banks, to a PLF agreement will be essential if the approach is to result in scaled-up financially sustainable pro-poor services. Experts interviewed within, or familiar with the workings of, multilateral financing institutions pointed to the need to understand their internal policies and procedures, and tailor PLF accordingly.

Most respondents were of the opinion that, even if the language of conditionality is shied away from at a policy level within the multilaterals, conditions relating to financial management and sustainability are a common feature of project design. Furthermore, the objective of incentivising financially sustainable pro-poor reform and service provision was shared by all experts interviewed, and ‘triggers’ for finance based on demonstrated pro-poor services or capacity to provide those services were viewed as something which could be built into program design. The importance of the institutions’ project cycle was referred to by a number of interviewees – with maximum scope for integrating PLF-style agreements within multilaterals’ projects to be obtained at the project preparation phase, even as the support for progress, and monitoring and verification of that progress, need to be maintained throughout implementation (a key gap in current approaches).

At the same time, the need for a financing agreement to be approved before any funds are disbursed limits the capacity of development banks, multilateral or

“ Emerging providers of ‘patient’ capital were identified as one possible contributor to a PLF arrangement ”

otherwise, to provide initial start-up funds or early-stage technical assistance. Consequently it is likely that one or more bilaterals or foundations would need to work complementarily alongside a multilateral institution providing finance for at-scale activities. Certain multilaterals would expect to work alongside other agencies in any case – for example the EIB, which will fund up to 50% of any project’s cost. A note of caution was sounded regarding the ease with which grant finance could be secured from bilateral donors, even for an innovative approach like PLF.

A further potential challenge for PLF is that the incentive structure within institutions such as the World Bank is largely based around designing a project that meets board approval and results in infrastructure on the ground. It is arguable that, within the incentive structure of conventional infrastructure projects, the extent to which functioning services are delivered has historically been viewed almost as an irrelevance. In addition, several experts pointed to the relatively cumbersome procurement rules and other safeguards that apply to multilateral agencies and development banks, which may present an obstacle to achieving progress and the disbursement of associated finance in a time-bound manner.

**Other sources of finance:** One expert pointed to the potential to extend the scope beyond the conventional categories of bilateral and multilateral financing institutions. The emerging providers of social impact finance or ‘patient’ capital – whereby social returns are expected in lieu of the high financial returns required for conventional venture capital investments (Acumen Fund, 2011) – were identified as one possible contributor to a PLF arrangement, given the mix of social and business objectives inherent in the concept. The potential to tap into domestic funds, including the local tax base, was also recommended to be given further exploration. Given the often opaque nature of local government finances, a first step would be to undertake an assessment of projected and actual municipal revenues, to assess whether, at a minimum, local taxes would at least permit reliable loan repayments.

### 3.2. What is involved: what constitutes progress, and how is it agreed?

Perhaps the area of greatest potential contention concerning PLF is how progress is defined, and what it is defined as. Whilst the ethical challenges around conditionality, such as the tension between ownership and results (Table 2-2), have been discussed already, the challenge is also a practical one – turning the rather abstract goal of commercially viable pro-poor services into a set of easily measurable, meaningful indicators.

In some respects, the answer to the question of how progress is defined (also offering the potential to resolve the tension between ownership and results) is relatively straightforward. The perspective of most experts interviewed, emphasised especially by service providers, was that conditions should be determined through consensual dialogue between the financing institution and the recipient on a case by case basis – to avoid a “master-slave relationship” in the words of one respondent. This is easier said than done – participatory processes are of course subject to asymmetries of power (Ostrom, Gibson, Shivakumar, & Andersson, 2011). Mitigating such power imbalances would require careful analysis and sustained effort from all parties.

The remainder of this section therefore focuses on the ‘what’ question. ‘Progress’, as defined under PLF, is to be indicated both by demonstration (of a commercially viable service delivery model for low-income settlements) and readiness (in terms of capacity to scale-up sustainable pro-poor services). Both sides of the coin are still relatively poorly understood – and there is continued debate not only about what pro-poor services and capacity look like, but also what proxy indicators can be used to readily assess them.

Most conventional key performance indicators (KPIs) used in contracts, financing agreements, management information systems and benchmarking have been oriented towards one aspect of the 'progress' envisaged under PLF agreements, i.e. technical and financial performance, as well as general capacity and customer services (see for example the indicators used to assess Water Operators Partnerships (WSP, 2009) and for the International Benchmarking Network for Water and Sanitation Utilities (IBNET, 2011)). The other aspect of progress, i.e. specifically pro-poor services, has received less attention in terms of development of metrics. That said there appears to be a surge of interest in developing more indicators to assess capacity for and implementation of pro-poor WASH services. Two important initiatives are singled out in Box 3-2.

### Box 3-2: Current efforts to develop pro-poor indicators

The *UNESCO-IHE PROBE* project is a 17-member partnership incorporating universities, operators and regulators in Africa, Asia and Latin America to develop pro-poor indicators, incentives, mapping techniques, and best practice. The project is beginning to field test its preliminary indicator set, which includes both output and process indicators. The preliminary indicator set includes five 'perspectives' – policies, collaboration, tools, sustainability and service provision – each of which is assessed according to a number of composite indicators, in turn scored according to various sub-indicators on continuous or categorical scales.

For example, one indicator for the Policies perspective is the 'Existence of a pro-poor water supply and sanitation (WSS) policy', which is scored against sub-indicators relating to whether the service provider prioritises service to the poor for water supply and sanitation, has community participation and gender components, and includes a financing mechanism for pro-poor service provision. The indicator for quality of sanitation services, part of the service provision perspective, is scored using eight sub-indicators which compare perspectives from user questionnaires (e.g. distance of facility from home, cleanliness, odour and technology type) with the utility's own estimate of coverage. The project is now looking to review and amend the indicator set as necessary, including the addition of certain indicators to assess 'in-slum' socio-political dynamics (Blokland, 2011).

In India's Gujarat and Maharashtra states, the *Performance Assessment System (PAS) Project* is developing a set of indicators for water, sanitation and solid waste service providers which are then used for benchmarking and developing performance improvement plans. The PAS project is sponsored by the Bill and Melinda Gates Foundation and is being implemented by the Centre For Environmental Planning and Technology (CEPT University) with support of the Urban Management Centre (UMC) in Gujarat and the All India Institute of Local Self-Government (AIILSG) in Maharashtra.

A major part of the project has been to develop equity-focused indicators which the project team noted were missing from conventional KPIs. The equity assessment looks at:

- The enabling environment, including the presence of a pro-poor policy, affordable tariffs, and inclusion of unregistered ("non-notified") slums
- Local preparedness, including the extent of funding in local budgets for poor/ in slum areas; and the presence of a network (water supply/ drainage) in slum areas
- Service delivery, including access to basic and improved services in slum areas (using the JMP definition), the extent of open defecation, the quality of services and complaint redressal).

The PAS as a whole is a five year cycle of data collection, verification, and analysis. A toolkit has been developed to support the performance improvement plans which service providers are required to develop on the basis of the enhanced information. This includes a list of remedial measures, making a distinction between low-cost and capital intensive options, and indicating the potential impact on service delivery, revenue, costs and financing. The project has also developed a GIS-based slum information system, recognising that the information deficit for pro-poor services often extends to simply understanding the location and configuration of poor urban settlements (Mehta, 2011).

“ Financially ‘ring-fencing’ low-income service areas would stimulate the development of innovative service delivery approaches ”

Furthermore, most experts interviewed recommended that financial sustainability should be an inherent component of pro-poor services, implying that the monitoring framework has as much to learn from existing KPIs as it does from the dedicated pro-poor indicators discussed in Box 3-2. The discussion which follows, of how to measure both demonstration and readiness components of progress, reflects this. While it is not within the scope of this paper to provide a list of actual conditions, the following indicates some key considerations which should be taken into account for the selection and development of indicators for financially sustainable, pro-poor services.

#### **Demonstrated, commercially viable pro-poor service**

The demonstration of commercially viable pro-poor services at a representative scale is a necessary part of the progress envisaged under a PLF agreement. In this regard, a first issue reflected on by interviewees was whether this demonstration project should be effectively ring-fenced from the service area as a whole.

Several respondents questioned whether it would be possible for the service provider to achieve financial sustainability from the revenues of low-income areas, without cross-subsidising from higher-income areas. This has a strong bearing on how ‘commercially viable’ is conceptualised and measured. If, for example, commercial viability is assessed in terms of the operating ratio – the ratio of operations and maintenance costs to revenue – should the revenues in question be confined to those within the low-income demonstration area, or include any available cross-subsidy from non-poor areas?

The question becomes even more pressing if ‘commercially viable’ is taken to mean covering some or all of the capital costs of the pro-poor demonstration project. The arguments given in favour of permitting cross-subsidies were both ethical – not forcing the poorest to meet the full costs of services – and political, given a policy requirement in some countries for service providers to cross-subsidise from non-poor to poor. On the other hand, financially ‘ring-fencing’ low-income service areas would stimulate the development of innovative, low-cost service delivery and revenue collection approaches and, if successful, would conclusively demonstrate that providing WASH services to low-income areas is not a loss-making business.

Overall it is likely that the design of a PLF agreement would need to determine the appropriate measure of commercial viability on a case-by-case basis, probably making a distinction in the extent to which (cross) subsidies are permitted for capital costs on the one hand, and operation and maintenance on the other. The PLF concept elaborated in this report assumes a ‘representative-scale’ demonstration, ranging from 50,000 to 200,000 people depending on the town and city in question, and the size and makeup of its low-income areas. Given this, and the heterogeneity of low-income settlements generally, the exact extent of affordability constraints will vary. It was recommended that observed valuation techniques be used to assess these constraints, rather than complex and expensive contingent valuation studies of willingness to pay. The high prices poor urban residents already pay for water from SSIPs is acknowledged as a useful benchmark for indicating the upper limits of their willingness to pay. In a similar spirit of flexibility, the possibility of having different measures of financial sustainability for the short- and long-term (or for the representative-scale demonstration and the eventual scale-up) was raised.

The above issues around financial sustainability arise from the need to set appropriate boundaries, which is an important consideration for the design of any metric, and was picked up on also in relation to sanitation services. Interviewees pointed out the need to consider the entire sanitation chain: that a viable business model for sanitation could not be construed as being limited to the provision of toilets, but has to consider how human waste would be removed, treated and disposed of, whether the technology

“One expert argued that household connections should remain a major ambition for low-income areas”

is on-site or networked. The assessment of a sanitation demonstration project would therefore need to assess how far these ‘downstream’ components are working effectively. However, the ability to recover any significant costs from the end of the sanitation chain (e.g. through compost or bioenergy) was brought into question by one expert. In such a case it was advised that the design, and assessment, of a commercially viable demonstration project for sanitation should focus on returns from ‘upstream’ components including sanitary ware (toilets and sinks) and waste removal services. An alternative implication is that the threshold for commercial viability would need to be relaxed in the case of assessing sanitation demonstration projects, in comparison to those for water supply.

In the case of sanitation, one expert questioned whether low-end, on-site technologies, while cheaper, might effectively lock poor-users into an ultimately unsustainable service, given the difficulties of safely emptying pit latrines in dense settlements. In view of this, the design of a representative-scale sanitation demonstration project as part of a PLF agreement would need to explore a range of technologies, including low-cost sewerage, sometimes referred to as ‘condominial’ or ‘small-bore’, and communal latrines.

Similarly, in the case of water supply originating with a utility, commercially viable pro-poor services may entail a range of different technology options, from tapstands and kiosks, through yard taps, to household connections. One expert argued that household connections should remain a major ambition for any attempt to serve low-income areas, because they permit greater revenue generation and are less prone to capture by “cartels” of SSIPs. Further arguments can be made for household connections in terms of convenience and health, permitting higher volumes of water use for hygiene purposes (Thompson, et al., 2001). Ultimately, the appropriate mix for either water supply or sanitation will depend on contextual factors including affordability, the legal framework, and the topography of the settlement in question.

A fundamental concern not picked up in detail in the interviews is defining who is poor (see Box 2-1). Good information on the distribution and extent of poverty is difficult to obtain, especially in relatively dynamic informal settlements and slums. The various methods (some would call them proxies) used to identify poor households have strengths and limitations in different contexts (Komives, Foster, Halpern, & Wodon, 2005). If a demonstration project is to be demonstrably pro-poor, such information would have to be collected and verified, whether by geographic location, self-reporting, means testing or community selection, and taking advantage of mobile and GIS technology as appropriate. The issue is also one of capacity (see below), whether for a demonstration project or city-wide scale up. Parties to a PLF agreement would also need to consider whether to use any existing locally applicable thresholds for poverty or develop its own.

### **Capacity for financially sustainable pro-poor services**

As indicated in the possible PLF arrangement outlined in Box 1-1, the development of capacity for financially sustainable pro-poor services may be a concern at different stages of the process – i.e. prior to granting finance both for a ‘representative scale’ demonstration, and prior to scale-up. It is likely, therefore, that this capacity would need to be defined and measured in an incremental fashion – with certain functions or institutional arrangements designated as essential for providing demonstration-scale activities, and others which could be developed later, prior to scale-up. As an example, there was some ambivalence among respondents over whether the initiation of a designated pro-poor unit should be used as an indicator of capacity to serve the poor. One respondent pointed to the difference between Nairobi City Water and Sewerage Company, where the informal settlements unit to some extent assumes an outsider

“ In Mozambique, FIPAG requires top performing utilities to pay their staff a bonus ”

role, advocating pro-poor positions to the wider management, and Manila Water, where a pro-poor culture is reported to be embedded throughout the management hierarchy, and there is thus no need for a specific unit. Aside from the broader debate over whether having an institutional structure in place is required in all instances, or guarantees that it will fulfil its role effectively, it might be envisaged that setting up a pro-poor unit would not be a pre-condition for demonstration-scale finance, but that it would be required as part of the capacity development for providing services at-scale.

Other aspects of capacity for commercially viable pro-poor services would need to be in place regardless of the scale of implementation. Several respondents commented on the need to ensure appropriate systems for cost recovery, on the basis that fixed weekly or monthly bills cannot be paid by low-income households. In such cases, the service provider may need to increase its staff at customer-level – as in Manila where “Territory Business Managers” and “District officers” are entrusted with considerable responsibility for managing services within the numerous subdivided service zones (Kim, 2006). Alternatively, using SSIPs as sub-contractors within a PLF agreement (Section 3.1) may complement or provide an alternative to the development of flexible revenue collection capacity in-house. The delegation of management of several small schemes to SSIPs by the asset holder FIPAG in Mozambique was noted by one interviewee to be providing promising results, which was attributed to their greater capacity for micro-management in low-income areas.

Other experts interviewed suggested that capacity development could be assessed relative to formal documents, such as medium and long-term plans for pro-poor service development, or formal commitments to serve peri-urban areas. While it is to be hoped that such undertakings would be an integral part of any PLF agreement, it again raises the issue, touched on in relation to specific pro-poor management units, that institutions and documents are markers for progress but do not guarantee a change of culture. This points to the need for both technical assistance and output indicators to ensure that fulfilling process indicators relating to capacity development does not become a tick-box exercise.

Other measures suggested to help PLF inculcate a deeper shift in culture include an effective incentive structure for staff at all levels. In Mozambique, under the delegated management arrangement, FIPAG benchmarks utilities against one another and requires top performers to pay their staff a bonus. The bonus should be met from the margin between their lease fee and the revenues the utility obtains from the system, ensuring staff have an extra incentive in maximising performance absolutely, not only in relation to the utilities it is benchmarked against. Weaker utilities with smaller service areas permitting lower revenues are effectively subsidised by a reduced lease fee so that their staff are not disadvantaged.

As mentioned throughout, pro-poor capacity requires broader business viability, so that constant fire-fighting does not detract from the momentum to extend services to the poor. This is, on the one hand, a matter of revenue generation, and on the other, cost minimisation, and it was suggested that affordable tariff structures (including connection fees) should be taken into account in assessing a service provider’s pro-poor progress. Perhaps the most important indicator of enhanced financial sustainability which is already widely assessed, and offers quick payback, is tackling non-revenue water. The fact that such aspects of capacity development are often the focus of ‘standard’ urban infrastructure projects, could be a further argument for building PLF into a larger project agreement, allowing PLF conditions to focus specifically on specifically pro-poor capacity issues.

## “ PLF may need to incentivise the development of a multi-sectoral sanitation policy ”

Interviews also pointed to the need to enhance both upward and downward accountability, for example by helping to strengthen monitoring and reporting capacities, and developing customer relations and management, specifically for low-income groups.

Given the very limited capacity that exists in the urban sanitation subsector for general service provision, let alone specifically pro-poor services, several interviewees pointed out that PLF may need to incentivise the development of fundamental policies and plans. This may be in the form of a multi-sectoral sanitation policy, agreed with health, water, education and other ministries. If the municipality has nominal responsibility and autonomy for urban sanitation in its area, then the first step may be to establish a general urban development strategy, into which sanitation is integrated alongside services such as water and drainage, and which can identify and propose solutions for socio-political and legislative constraints, for example unclear status of informal settlements or limited obligations on landlords. Again, in such situations, and indeed where tariff reform is politically resisted, it may be more appropriate for PLF to be integrated as a relatively small part of a much larger urban development program with the leverage to achieve multi-sectoral regulatory and policy change.

In terms of specific measures to enhance capacity to provide sanitation services to the urban poor, one respondent pointed out that mechanisms should be developed to ensure the poorest can purchase or build adequate sanitation facilities. Where significant hardware subsidies are not available, and given the limited efficacy of zero-to-low subsidy approaches in urban areas, it was suggested that a revolving fund or similar cost-spreading mechanism should be initiated, as used by UN-HABITAT and the Government of Madhya Pradesh, India (UN-HABITAT and Government of Madhya Pradesh, 2006). The need for integration of SSIPs was also emphasised, for example for pit emptying. While formal, supervised arrangements would likely be necessary, one respondent argued that the critical health benefits associated with sanitation would be achieved by removing excreta from the immediate domestic environment, and consequently recommended taking a pragmatic attitude to SSIP involvement in waste collection and disposal, for example by utilising private composting businesses rather than insisting on a municipal waste handling system.

### **From defining progress to measuring it**

The definition of progress, as defined within a PLF agreement, must allow that progress to be measured if the agreement is to be effectively enforced. Table 3-1 below suggests how the SMART principles for indicator development – specific, measurable, acceptable, realistic and time-bound – might be applied in the case of PLF. Appendix 1 lists pro-poor indicators proposed by several recent studies, to further inform the development of PLF indicators. The issue of what to measure is also considered further in relation to verification of progress, in Section 4.2.

*Table 3-1: SMART principles and how they might apply to defining and measuring progress on sustainable pro-poor services.*

Principle	Implications for defining PLF 'Progress'
Specific	Progress should be determined relative to a limited number of indicators, each of which has a specific purpose relative to demonstration of or readiness for financially sustainable pro-poor service provision. In the case of demonstration, for example, indicators should be selected to show, at minimum, financial sustainability and achievement of representative-scale outputs in terms of improved access to WASH services for poor urban residents
Measurable	PLF is likely to require a combination of process and output indicators. These may be assessed in categorical terms (e.g. has the service provider developed a plan for engaging SSIPs within its service area, or not) or in continuous terms (e.g. what is the average reduction in the price paid for water by newly connected poor households). Process indicators are perhaps more likely to be assessed in categorical terms, and output indicators in continuous terms, though this is not a hard and fast distinction. PLF indicators may also be quantitative or qualitative. Though thorough triangulation is important in all cases, it is especially so in the case of qualitative measurements, which may be disputed by different parties. In the case of all indicators, measurement can only be effectively undertaken once the baseline is known, which should be established prior to each stage of the PLF process commencing.
Acceptable	Progress should be defined and measured in terms of indicators that are acceptable to all parties. For both service providers and financing institutions, attribution may be an important issue: confidence that progress achieved, or not, is the result of the service provider's efforts, and not happenstance. The principle of acceptability further strengthens the argument for defining progress in a consensual, participatory manner, on a case-by-case basis for each PLF agreement.
Realistic	The threshold set for each indicator, at which 'progress' is deemed to be sufficient to merit finance, should be achievable given the time and resources available – a compromise between ambition and pragmatism. It may be that having a number of thresholds, each triggering a higher (or more concessional) volume of finance, may prevent unrealistic thresholds.
Time-Bound	The timing of a PLF agreement may be largely determined by the time-frames of donor staff and project-cycles, as well as parliamentary terms. But within these broader constraints, clear due dates should be set for the achievement of progress associated with each stage of a PLF agreement.

“ PLF could be awarded according to the extent of progress on a ‘bronze-silver-gold’ basis ”

#### 4. The L in PLF: Linking

Though defining progress is a major piece of the PLF puzzle, establishing an effective link between progress and finance requires more than developing a list of indicators. This section considers further intricacies of PLF agreements – on the one hand, the institutional architecture and principles for enforcement of conditions, and on the other, the associated activities of supporting service providers to achieve progress, and verifying those achievements.

##### 4.1. Architecture and operating principles for PLF

A distinction must inevitably be made between the likely architecture to ‘house’ a PLF agreement at pilot stage and the ideal arrangement for PLF once it has been trialled and buy-in from a broader range of stakeholders can be obtained.

In terms of the former, the institutional arrangement would be to a large extent determined by expedience – which financing institutions and service providers, in which countries, are willing to engage in piloting an as-yet untested approach. However, feedback from most experts interviewed was that there was little, in principle, that would prevent their institutions from engaging in PLF in some capacity. It may be that PLF approaches would initially be trialled as part of a dedicated pro-poor component within a larger urban infrastructure project. As mentioned, this could in any case have advantages, for example: allowing the PLF component to focus exclusively on dedicated pro-poor measures rather than general operational and commercial performance; and potentially enabling major upstream reforms to be leveraged through the broader project’s engagement with a range of urban stakeholders, including planners.

In the long-term, a more sustainable architecture would need to be devised to house funds (see also Box 4-1). Several experts pointed to the possibility of setting up a trust fund or similar facility – whether at international (or regional) level or, if there are sufficient utilities or municipalities to create a competitive environment, at national level. The possibility of integrating a ‘challenge’ component to such a fund whereby prospective recipients compete for funding, for example on the basis of a proposal for a pro-poor demonstration project, was suggested as an option. An alternative proposed was to introduce a competitive element in the assessment of progress: where several service providers of similar size and type could be found to enter into parallel PLF agreements, PLF could be awarded according to the extent of progress – for example on a ‘bronze-silver-gold’ basis, where the service provider achieving the greatest improvement receives the top prize of concessional finance for city-wide scale-up. Such an awards system might need to be weighted to account for differences in ‘starting position’: so the ‘gold medal’ would be for the greatest improvement, as opposed to the highest end position.

Use of a trust fund might help to overcome some of the timing constraints imposed by the 1 to 2 year programming cycle which is usual for most financing institutions. Whereas financing institutions may be unwilling or unable to commit to pay service providers directly over larger timeframes, the trust fund would act as a legitimate holding account, allowing the donor to claim any funds put in as disbursed, even if they are actually released to the service provider at a later stage. On this issue of timing, there were mixed views on how far to break down any overall PLF agreement into a series of stepped agreements: on the one hand, this would allow finance to be committed to reward progress made over a shorter time frame; on the other hand, each additional stage would likely increase the transaction costs involved.

“ Use of a trust fund might help to overcome some of the timing constraints usual for most financing institutions ”

One expert pointed out that trust funds are often in any case bound by the procedural requirements of the institutions which fund and manage them: for example World Bank-administered GPOBA projects are subject to the Bank's rules on procurement (GPOBA, 2009a, p. 10). For this reason, some respondents suggested that alternative institutional setups outside the traditional development space should be explored, for example social impact finance. But while such sources may be able to fund representative-scale demonstration, it is difficult to see them meeting the costs of city-wide scale up, which remain the likely preserve of multilateral development banks.

Recognising the risks of undermining alignment and harmonisation (Table 2-2) by creation of a further separate project-based modality, interviews also explored the potential for utilising PLF in the context of sector-wide or programmatic approaches. Experts did not generally perceive a problem with building performance-based pre-conditions into SWAp or basket funding. It was furthermore suggested that 'shadow-alignment' (DFID, 2010), whereby a project is designed on PLF principles, but oriented to coincide with national priorities, might be an attractive proposition to those financing institutions that are prohibited from joining a SWAp directly.

In procedural terms, consideration should also be given to the extent to which any conditionality inherent in PLF is enforced. Whilst the aim of PLF is to create meaningful incentives for progress, there are certain advantages to taking a more flexible approach. The need for donors to show through-put of funds has already been mentioned - in the context of conditionality, donors may be unwilling to route funds through a mechanism which might lead to underspending against their allocated budgets. From the service provider's perspective, at least one expert argued that the consensual principles which are applied to the development of progress indicators in the first place, should follow through to the enforcement of those conditions, i.e. leaving room for negotiation where extraordinary circumstances have delayed progress. In such cases, rather than waiving conditions entirely it may be appropriate to have clear procedures for postponement, potentially including remedial measures, e.g. closer supervision of progress measures being undertaken.

**Box 4-1: Institutional models for the PLF approach**

The following reflects on a number of financing mechanisms which have been applied to urban WASH financing, and which have characteristics which could be relevant to the design of an institutional architecture for the PLF approach in the longer term.

In the Philippines the 'Graduation' concept has been developed to incentivise operational and financial improvement among Water Service Providers (WSPs). In place since 2004, the approach makes different financing options available to WSPs based on their step-wise progression towards credit-worthiness (four categories are defined: non-creditworthy, pre-creditworthy, semi-creditworthy and creditworthy). WSPs are also incentivised to progress through their 'graduation plan' by gaining increasing levels of operational autonomy. An interagency oversight committee supervises the process, led by the Department of Finance and including various other government departments and the Local Water Utilities Administration, which is required to develop guidelines and monitor the progress of WSPs (Office of the President, 2004). The Graduation concept is thus embedded in existing national structures - a possibility in the context of the Philippines where capacity is already reasonably high.

In Kenya, the Water Services Trust Fund (WSTF), a State Corporation established in 2002, is mandated to provide financing assistance to unserved areas. Most budgetary allocations come from the Government of Kenya, complemented by various bilateral and multilateral financing institutions. The model is demand-led, requiring eligible entities to apply for funding for three main activities: urban and rural water services, and development of Water Resource Users Associations. In the case of the urban window (the Urban Projects Concept), water service providers are encouraged to apply to the WSTF for project funding to enhance water supply and sanitation services in low-income districts within their service areas. Proposals are prepared in collaboration with the asset holders, the Water Services Boards, and are assessed against data regarding the baseline and intended impact for pro-poor services. The Urban Projects Concept shares some characteristics of PLF, including its pro-poor focus, but does not require demonstration of a commercially viable pro-poor service model. It is, however, an interesting example of a dedicated pro-poor trust fund established at the national level (Zambia's Devolution Trust Fund is a further example).

The GPOBA has already been extensively referred to, since in the eyes of many experts interviewed it represents the most obvious 'model' for institutionalising the PLF approach at an international level. A trust-fund administered by the World Bank, which is also one of six partners including AusAID, IFC, DGIS, Sida and DFID, the GPOBA designs and implements output-based aid schemes focusing on sustainable, pro-poor basic services. It is also working to increase uptake of, and share learning on, OBA among other governments and financing institutions. The GPOBA is evolving its procedures. Having identified barriers to service providers taking part, including the issue of access to funds to pre-finance infrastructure, it has sought solutions including the use of micro-finance loans, as applied through K-Rep bank in Kenya (Kumar, Lieberman, & Mumssen, 2010). Given its similar overall objective to PLF, the international trust fund for OBA offers useful lessons for the long term goal of institutionalising PLF at international level. Particular characteristics highlighted by experts interviewed included the separation of windows for implementation, technical assistance and learning and dissemination, as well as the ability to utilise the expertise and capacity of World Bank task managers in-country for capacity building and supervision. Different subsidiary ("non-core") funds permit IFC, DFID and DGIS to adapt the general model to their own procedural requirements. The GPOBA Operating Principles provide a wealth of detail on the design and implementation of an international trust fund for basic services (GPOBA, 2009a).

“ The PLF concept requires that financing institutions support service providers in their development of capacity for sustainable pro-poor services ”

## 4.2. Supporting and verifying progress

### Supporting progress

The PLF concept requires that financing institutions not only reward progress with finance, but that they support service providers in their development of capacity for sustainable pro-poor services and, potentially, in developing and demonstrating a commercially viable, pro-poor service delivery model. For one service provider, the expert interviewed estimated that capacity development would be required across a very wide range of functions, including:

- Management capacity (management information systems, business management)
- Technical capacity (network and asset management)
- Financial capacity (public-private partnerships, fundraising)
- Monitoring and evaluation capacity (including self assessment)

A further important aspect of capacity for sustainable pro-poor services, often underdeveloped, is the existence of systems for community liaison, and customer accountability, especially where the relationship between service provider and poor urban residents has been hitherto non-existent or acrimonious (for example due to illegal connections in low-income settlements).

Project preparation support was emphasised by another respondent, which could be required both for the development of a representative scale demonstration project, as well as eventual scale-up of activities. For sanitation specifically, a particular capacity building need noted to be often overlooked is general urban planning expertise, or more specifically the ability to advise sanitation service providers on how to fit within the broader urban space. Ultimately, as suggested by one expert, it is likely that support needs would have to be determined in a collaborative manner between financing institution and service provider, depending on existing capacity and the manner in which progress is defined. In terms of more general financial and operational capacity, a possible mechanism to assess specific needs that was highlighted during interviews is the concept of a ‘shadow credit rating’. This process, undertaken with WSP and PPIAF support for five service providers and two asset-holding bodies, can help WASH institutions in developing countries to understand the principle issues which undermine their financial sustainability (Global Credit Rating Co., 2008). While the objective of the original WSP/ PPIAF shadow ratings was to help service providers move closer to being able to access commercial finance, a similar process could be used to identify capacity building needs – perhaps adapted to include specifically pro-poor elements, besides cost recovery and efficiency.

None of the experts interviewed questioned the need for such support, or pointed to the en vogue Cash-on-Delivery approach which attempts to let recipients find their own solutions, on the grounds of both cost-effectiveness and ownership. Interviews did, however, reveal that the costs associated with supporting service providers would be high, especially if capacity development extends to subsidiary recipients such as SSIPs. It was nonetheless argued that these costs were inevitable, and that PLF would not necessarily involve capacity development costs orders of magnitude higher than standard project approaches. One way to safeguard value for money would be to include some performance-based payments in the contract with the support provider, e.g. conditional on the supported service provider achieving the required progress.

“ There are currently few third-party providers of specifically pro-poor support services ”

As to how capacity development support is provided, a number of options were proposed:

- The service provider tendering for support services. It was pointed out that there is a relatively well established model for utilities in developing countries to tender contracts for ancillary services – for example for billing and collection. However, it was also noted by some respondents that on the supply-side, there are currently few third-party providers of specifically pro-poor support services. Two respondents suggested that the model of water operators partnerships, which attempts to overcome this knowledge gap by utilising exchange and transfers between service providers themselves, could be integrated with PLF. In such a case, a partner service provider with greater capacity would be contracted to provide support to the PLF recipient, to help it develop a demonstration-scale pro-poor project, or develop its pro-poor capacity. Where there are sufficient specialist providers of ‘low-income services’ to make competitive tendering possible, this may be the preferred route.
- Conventional technical assistance provided by a bilateral donor. The bilateral financing institutions consulted for this study expressed their interest in providing technical assistance services, if more substantial infrastructure finance were provided by a multilateral development bank. At least at pilot stage, this arrangement would probably be synergistic, given that multilaterals may struggle to provide substantial TA prior to signing of a project agreement.
- Technical assistance provided through a separate trust fund window. At a later stage, if PLF were institutionalised within a dedicated trust fund, the GPOBA’s ability to provide technical assistance through a separate funding window offers a useful model, as is the fund’s ability to draw on World Bank task managers.

### Verifying progress

In terms of verifying progress, a number of ideas were offered by experts interviewed. A first issue is the cost of verification – transaction costs associated with OBA have in some instances been high because of the use of relatively expensive auditors to verify outputs and the detail with which access and service quality has to be assessed. PLF would likely avoid some of these costs, as progress is to some extent assessed against process indicators which are often less time consuming to verify. But at the same time a degree of output verification will be necessary (for example in relation to any pro-poor demonstration project).

Assuming that in most cases a range of technologies would be required to meet different price points, there remains a question of which outputs to measure. Several respondents reflected that the high verification costs pertaining to OBA for water services have been incurred in relation to assessing high-end service options, namely enumerating individual household connections, which are also usually tested for water quality and service continuity (GPOBA, 2009c). In view of this, it was suggested that an assessment of PLF outputs, whether at representative scale or in the case of eventual scale-up, might seek to economise. This could, for example, be achieved by verifying a randomised sample of high-end outputs (i.e. household connections), and testing all lower-end, or shared technology options, using a limited number of indicators – for example, the income generated by a water kiosk, the number of customers served per month, and the volume of water sold.

“ The service might be assessed primarily by consulting users through simple customer satisfaction scorecards ”

Notwithstanding the need for rigorous, independent external verification, one respondent emphasised that data should, wherever be possible, be obtained from the service provider itself, with a sample selected for external audit. Alternatively, or additionally, the service might be assessed primarily by consulting users, for example through simple customer satisfaction surveys or scorecards – though the service provider may resist this if the results of such surveys are deemed to be somewhat removed from their direct control. A further alternative to using expensive consultants or audit companies to verify progress, suggested by one respondent, would be to utilise local banks – at least for assessing financial viability, as they would likely have a much better idea of the local risk environment.

But beyond cost-saving arguments there are arguably more important reasons for utilising local systems as far as possible: strengthening accountability and sustainable monitoring and evaluation capacity. This could require development of the service provider’s existing systems or instituting new ones, including customer databases, complaints and response logs, poverty mapping and targeting, and customer satisfaction tools such as scorecards.

Whatever the method chosen for data collection, adequate attention should be given to establishing the pre-intervention baseline, as well as the ultimate progress achieved.

“Several respondents remarked upon a potential synergy between bilateral financing institutions and development banks”

## 5. The F in PLF: Finance

This final section on the practicalities of designing and implementing a Progress-Linked Finance agreement focuses on the third piece of the puzzle, the finance itself. Specifically, how the funds attendant on a PLF agreement might be sourced and sequenced, and how they could be used.

### 5.1. Sourcing and sequencing Progress-Linked Finance

While this study focused on refining the PLF concept, drawing on expertise within financing institutions and service providers, experts were also consulted on whether they perceived the concept to be of potential value to their specific organisations. While this in no way can be taken to be a commitment to participate in a PLF pilot, it reveals several issues including the likely ease with which funding could be secured for different parts of a PLF agreement.

As mentioned, several respondents remarked upon a potential synergy between bilateral financing institutions or foundations spearheading the PLF process with technical assistance and potentially grant funding, and multilateral development banks stepping in to provide scale-up finance once a model for commercially viable pro-poor services has been demonstrated.

However, doubts were nonetheless expressed over whether funding would necessarily flow to an approach such as PLF – given that well established approaches such as OBA sometimes struggle to attract finance and the overall aid environment appears increasingly constrained following the financial crisis. It should be kept in mind that PLF would compete in a crowded marketplace for scarce funds, and whatever its potential niche, would need to demonstrate that it achieves added value relative to alternative routes for international concessional WASH finance, or as a specifically pro-poor component within a conventional large-scale urban infrastructure project.

While the funds required to finance pro-poor infrastructure at scale are likely to be significantly higher than for a demonstration project, it cannot be taken for granted that they would be easier to source for the latter – given that most of the experts consulted were of the opinion that, for an initial pilot PLF agreement, this would need to come from a bilateral finance institution with inevitably smaller resources. But it is necessary also to ask to what extent demonstration-scale projects should be financed from external resources. In contexts where service providers are able to finance a proportion of capital costs internally, they should perhaps not be subsidised when it comes to capital costs associated with low-income areas (assuming that these costs would not be passed entirely to the prospective customers in these areas). Certainly, the ability for PLF to leverage domestic resources is something likely to appeal to financing institutions.

Assuming that finance can be sourced, the way in which its disbursement is sequenced will play a part in creating incentives. The idea of releasing some funds on a ‘bonus’ basis, with incrementally higher levels of progress rewarded with incrementally higher levels of finance has been mentioned. It was also suggested that loan terms could also be used as an incentive – with increasingly attractive terms the further a service provider progresses along the PLF pathway. This would need to be set against the risk from the perspective of the service provider, which underpins the sequencing suggested in Figure 1-3 – grant finance front-loaded to encourage the service provider to undertake a demonstration project; loan finance for scale-up once the model has been shown to work.

“ A potential use of PLF is to leverage other forms of finance beyond conventional concessional grants or loans ”

## 5.2. Utilising Progress-Linked Finance

Progress-Linked Finance is likely to entail a series of financial injections as iterative rewards for progress. But it is likely to be the offer of finance for scale-up at the end of the PLF process which constitutes the most attractive prize. What this end-goal PLF finance is ultimately used for may, at first sight, appear self-explanatory: given the specifically pro-poor emphasis of the entire approach, it seems natural that any concessional finance released upon completion of the PLF process would be earmarked for services to low-income areas, as per Figure 1-3.

It may be worth giving further consideration to whether non-earmarked finance could provide a greater incentive for the service provider. If some degree of cross-subsidisation is viewed as a practical and ethical necessity, the service provider may be unwilling to rapidly expand its services to low-income areas without equivalent expansion in higher-income parts of the city (so as to maintain the overall cross-subsidy balance). Furthermore, investing in general utility production and distribution capacity has been shown to provide benefits to poorer segments of the urban population even if they do not gain connections, because it can drive down the premium attached to water resold by vendors (Keener, Luengo, & Banerjee, 2008). It is also important to ask whether finance would exclusively be used for infrastructure construction, expansion and rehabilitation, i.e. hardware, or also for software. In the case of sanitation and hygiene especially, where software components would likely include significant marketing and sensitisation activities such software would have a clear social purpose. But more general software activities, including capacity strengthening in recruiting and training staff, can play a part in increasing financial sustainability and service quality.

However, the argument for permitting the service provider a degree of discretion over how it spends any concessional finance awarded at the close of the agreement - for hardware or software - requires PLF to successfully reorient the service provider to be as willing and able to serve poor areas as it is to serve non-poor areas. In most cases this may be wishful thinking: old habits die hard, and earmarking would be necessary to ensure service providers continue to invest in low-income areas as they scale up.

The above points again lend themselves to the idea that PLF could be used as a pro-poor component within a larger urban project, with the funds attendant on progress earmarked for pro-poor activities (e.g. service extension and marketing and promotion to low-income areas, as well as continued reduction of non-revenue water), while the remaining (larger) share of general project funds are not earmarked in this way, but offered in a conventional fashion for core operations and general expansion.

A final potential use of PLF is to leverage other forms of finance beyond conventional concessional grants or loans. In this case, satisfactory progress at the end of a PLF agreement (developed pro-poor capacity and a demonstrated, commercially viable pro-poor service model) would trigger not further traditional concessional finance, but finance from different sources such as commercial credit or patient capital (see Section 3.1), or innovative development finance such as OBA.

The expectation that PLF will increase financial sustainability by enhancing general operational capacity and extending the service area and revenue base gives it the potential to make service providers considerably more attractive investment prospects for private or social investors. Some doubt was expressed by interviewees whether the majority of service providers in Sub-Saharan Africa would be able to seek finance on fully commercial terms, even after receiving capacity building support and a demonstrating a viable pro-poor model under a PLF agreement. In such cases it may be worth exploring the possibility of seeking patient capital, with its greater acceptance

of risk and longer repayment thresholds – though it is not clear that the availability of such capital ('social impact finance') is yet sufficient to finance city-scale infrastructure. An alternative may be to use blended finance, whereby concessional funds are used to attract co-financing from commercial creditors. In Mozambique the European Investment Bank has provided a core infrastructure loan, supported by grant finance from the EU Water Facility, AFD and others. Via an OBA component, the project awards sub-contracts to SSIPs who are able to approach the commercial banking sector for credit thanks to the security provided by the OBA. Alternatively, international financing institutions may be willing to provide a credit guarantee to reduce the risk perceived by prospective commercial creditors, though there are issues around currency risk which mean such guarantees are rarely applied in the water sector (OECD, 2010).

Another option would be for the financing institution to offer the service provider further dedicated project preparation support, to develop a bankable city-wide project incorporating low-income areas, on completion of the PLF agreement. However, one respondent reflected that past experience with project preparation facilities for the water sector had been mixed: while substantial funds were committed, demand remained restricted with insufficient projects developed. In part this is attributed to the lack of support for upstream reforms, including the policy and regulatory environment (Leighland & Roberts, 2007), which may also be required for PLF to succeed (Section 3.2).

The final possibility to note in terms of leveraging additional finance would be to utilise PLF as preparation for further results-based finance agreements, for example OBA or COD. In principle the PLF component would be designed to help the service provider enhance its business model – both pro-poor and general – to the extent that it is able to pre-finance expansion of services city-wide. The OBA or COD component would then be layered on as an additional incentive to ensure that this expansion benefits low-income areas as much as any other.

However, despite the allure of innovation associated with these financing options, it is critical to note that respondents questioned whether they would act as sufficient incentive to the service provider. The prospect of straightforward concessional finance (grant or loan) for scaling up services is at least dependent on the service provider's own ability to achieve progress. These more 'innovative' options may simply increase the uncertainty: in the case of output-based aid, the risk of not being able to prefinance, or ultimately achieve, required outputs; in the case of commercial finance, the risk of being unable to develop a bankable project.

## 6. Progress-Linked Finance: piecing the puzzle together

Sections 3-5 have highlighted critical aspects of PLF design and Implementation from a wide range of perspectives, from the institutional setup, to how finance attendant on progress is ultimately used. Table 6-1 draws this discussion together, showing the range of possible variation in the PLF model across these different perspectives (note that the table is not intended to be read in a downward manner – different options in each row may be compatible with various different options in other rows).

**Table 6-1: Principal components to consider in PLF design and implementation.**

### PLF institutional arrangement

Institutional setup for PLF	Component of conventional IFI project	Standalone projects		Component (or shadow component) of programmatic funding
Financing institution: TA/demonstration phase	Foundation	(through Trust Fund or independent)		Development bank
Financing institution: demonstration / upscaling phase	Foundation	Bilateral grant-making		Development bank

### Urban context

Settlement type	Peri-urban	Inner city slum	Mixed wealth urban	Small town
Main service provider	Informal		Formal	
	Utility		Municipal department	
Initial capacity of service provider	Low	s	s	High

### PLF focus

Subsector	Water		Sanitation & hygiene	
Technology type	Networked	s	s	Non-networked
Additional actors	SSIPs	Regulator	Municipal departments	National government

### PLF design

Type of finance	Grant	Mixed grant and loan	Loan: highly concessional	Loan: less concessional
TA provision	Financing institution own staff	Consultancy		WOP
Readiness indicators	Policies	Tools		Capacities
Demonstration indicators	Processes	Inputs	Outputs	Outcomes
Verification arrangements	Self-reporting	Self-reporting with independent audit		Full independent verification by IVA
	Top-down			Community-driven
Disbursement arrangements	Fully conditional finance		Conditional components with larger financing package	
	Fixed-size tranches		Variable tranches / bonuses	
	Fixed timing of disbursement		Flexible timing / floating tranches	
Use of financing triggered	Concessional finance earmarked for pro-poor services	Concessional finance, non-earmarked	Leveraging of OBA / COD	Leveraging commercial finance

## “ What level of starting capacity of the service provider is appropriate? ”

The first set of possible variations in Table 6-1 relate to the institutional home of PLF and the way in which it is integrated into existing donor financing arrangements. The scope for flexibility in subsequent design of a specific PLF agreement (in areas such as financing terms, verification methods and disbursement terms) may be limited to an extent by this initial decision. Choices here may also play a major part in determining the ultimate reach of a PLF agreement: as noted, major scale-up finance is more likely to come from a multilateral development bank than a bilateral or foundation.

The second set of possible variations is associated with the contexts in which PLF is to be piloted and applied. These relate primarily to the particular features of different settlements and service providers, but consideration of these factors may inform the selection of countries and cities/towns for piloting and ultimately mainstreaming PLF – for example, what level of starting capacity of the service provider is appropriate? The selection of countries or cities may also be dependent on the particular financing institution(s) engaging in PLF, particularly for foundations or bilateral development agencies who may have presence in relevant sectors only in a limited number of countries.

The third set of variations is to do with the sub-sector(s) on which a PLF agreement will focus: water supply, sanitation and hygiene, or both. (PLF may also be applied to related parts of the water cycle or sanitation chain such as wastewater treatment and urban drainage, though these are not mentioned specifically in the table.) For each sub-sector, there is then a choice when it comes to technology types appropriate to sustainable pro-poor services (broadly divided into networked and non-networked, though these encompass a range of options both individual and communal, centralised and decentralised). These decisions, as well as initial contextual factors, will in part dictate the range of other national and local actors who will need to be engaged in the PLF. SSIPs, regulators, relevant municipal departments and national policymakers are likely partners which should be considered.

The final section of the table deals with decisions in the design of a particular PLF agreement. Some room for flexibility in these decisions is recommended in order that the PLF can be adapted to provide appropriate support and incentives in different contexts. However, both the type of financing and the arrangements for TA provision, verification and disbursement may be dictated by the rules and procedures of the financing institution(s) involved. Actors involved in PLF will need to decide to what extent measures of readiness and demonstration are to be standardised across countries/cities, and whether the ultimate use of the finance triggered will be the same in every case.

“ The PLF concept of using structured pre-agreements to incentivise progress was viewed as a broadly feasible ”

## 7. Conclusion and recommendations

As Section 6 indicated, the analysis of the practical implementation issues associated with PLF in Sections 3 to 5 yields a multiplicity of options. This reflects not only the differing opinions of those consulted, but also the multiple contexts in which the essential components of a PLF approach could be applied. The interviews and analysis have attempted to remain true to the overall goals of PLF – to leverage better pro-poor capacity and viable business models – while accepting that in the event of implementation a PLF model, whether a pilot or fully institutionalised approach, may ultimately take a different form from the one presented in Box 1-1 (and, in particular, from the precise sequence of iterative progress and reward depicted in Figure 1-3).

At the same time, the research and conversations underpinning this paper did not indicate any fundamental obstacles to using PLF-type approaches, from either the perspective of service providers or financing institutions. Rather, there was broad interest from all parties, indicating that: the overall PLF goals are commonly held across sector actors; that there is a real desire to develop better mechanisms to achieve those goals; and that the PLF concept of using iterative, structured and well-supported financing pre-agreements to incentivise progress was viewed as a broadly feasible.

However, it is also necessary to note certain caveats. First, that at this early stage the PLF concept needed to be introduced with brevity, and in a sufficiently generalised way that it could be understood as relevant by all experts interviewed. The perspectives offered in the course of each interview may thus reflect the limited scope for elaborating the concept beforehand (though this may be an advantage, giving greater room for respondents to offer their own original ideas). Second, that the pool of experts consulted, while broad and extremely knowledgeable, was limited by the time-frame allocated to the study. Further external consultation would therefore be advisable in the course of designing a PLF pilot. The need to identify and consult with appropriate municipal officials including, but not limited to, those with responsibility for sanitation, is particularly pressing, though further consultation with practitioners within utilities, and indeed SSIPs, is also advised. Third, that reservations were expressed by some respondents regarding certain key details of the PLF concept – namely the conditionality and project-oriented nature of the approach, which may run counter to the aid effectiveness principles of ownership, harmonisation, alignment and mutual accountability. Nonetheless, as has been made clear throughout this report, the careful design and implementation of PLF has potential to mitigate those concerns.

Below, PLF is re-evaluated against the five principles from the Paris Declaration on Aid Effectiveness presented at the close of Section 2, in the light of the issues discussed in Sections 3 to 5.

Table 7-1: Re-evaluating PLF against the Paris Principles on Aid Effectiveness.

Paris Principle	PLF's potential 'fit'
Ownership: <i>Developing countries set their own strategies for poverty reduction, improve their institutions and tackle corruption.</i>	The extent to which PLF could support or undermine ownership is to a large extent a function of whether conditions are set by the financing institution(s) or agreed in a consultative manner. Given the substantial work done in recent decades to increase countries' ownership of their own development agenda (an expressed intent of the PRSP process) it is important that new financing approaches such as PLF do not undermine these efforts. While it is perhaps unlikely that donors would relinquish all control over what sustainable pro-poor service provision 'looks like' (a possible explanation for the as-yet limited use of COD), there is potential for conditions to be developed in a participatory manner and aligned with existing national (and service provider) priorities. The objectives of PLF are also firmly in the interests of the service provider, as well as the ultimate beneficiaries (poor urban residents). Properly articulated, the prospective benefits of an enhanced revenue base (extension to unserved areas) and operating and commercial efficiency (enhanced capacity) could motivate service providers to take ownership of a PLF process.
Alignment: <i>Donor countries align behind these objectives and use local systems.</i>	While PLF, in its initial form, could constitute a further parallel structure it is also possible that PLF principles could be integrated into existing aligned aid approaches, where they exist: for example, in countries with a developed Sector-Wide Approach (SWAp) for the WASH sector, PLF could be applied either within the SWAp basket funds or by financing institutions unable to join the SWAp itself, but willing to support it through 'shadow' or 'halfway house' mechanisms. In situations without clearly defined development objectives for WASH services, it may that a PLF process could substantively contribute to articulating those objectives. Finally, PLF stands to contribute to alignment in the longer-term by using and strengthening service providers' own systems (planning, MIS, etc.).
Harmonisation: <i>Donor countries coordinate, simplify procedures and share information to avoid duplication.</i>	The extent to which PLF could strengthen harmonisation between donors depends to some extent on the level of buy-in. However, as discussed in Section 3.1, PLF may innately encourage synergies between several financing institutions, for example between a bilateral donor providing smaller-scale grants for investment and TA to support the start-up of PLF processes, alongside development banks who are able to provide at-scale finance, most likely as a concessional loan. Furthermore, the information generated in the course of PLF implementation and verification could be shared with other sector partners.
Results: <i>Developing countries and donors shift focus to development results and results get measured.</i>	There is continuing debate over whether the renewed emphasis on results among some financing institutions is overall a good thing (see, for example, Eyben (2011) vs. Melamed (2011)). If any consensus can be extracted, it is that it helps if what is being measured increases real understanding: not just that outputs or outcomes are achieved, but how and why they are achieved. PLF focuses both on the capacity to develop sustainable pro-poor services (process), and the implementation of those services, whether at demonstration level or at-scale (output). This is one way in which it is distinguished from OBA and COD. But this in turn rests on the link between process and outputs being effectively made: if results are not achieved (e.g. if the demonstrated pro-poor business model does not achieve intended outputs, or outcomes) then it is critical that a genuine and reflective learning process is undertaken to establish why, and how it can be improved.
Mutual accountability: <i>Donors and partners are accountable for development results.</i>	The extent to which PLF could provide accountability benefits again largely depends on design, in particular: how far criteria are devised, monitored and enforced in a transparent and evidence-based manner. But it is important that the most obvious accountability dynamic of PLF – holding service providers accountable and rewarding them for sustainable pro-poor services – is not allowed to dominate. Other accountability dynamics are important. The accountability between the financing institution and the service provider is critical and needs to be based on mutual understanding: this may require some flexibility on enforcing conditions where external factors prevent progress, and ensuring that a PLF approach does not excessively undermine predictability of funding. For the financing institution, the attraction of PLF may be that it provides stories and measures of progress with which to account to the public of home nations or, in the case of multilaterals, contributing donors. Finally, PLF should also take care to reinforce accountable relationships between service provider, government and citizens, for example by involving wider sector institutions in the design and implementation including user groups, federations of the urban poor, regulators and civil society.

“ Even where bottlenecks to pro-poor service delivery are deeply rooted, ambition on the part of service providers may be very powerful ”

Ultimately then, the headline finding is that Progress-Linked Finance merits development and testing.

In the short term, this could be achieved through a pilot project. Various options can be conceived. One would be to seek to integrate a PLF component within a larger urban infrastructure project from a multilateral development bank – seeking interested project managers who have the capability to embed PLF elements at project design phase (navigating any prohibitive institutional policies) with the support of a smaller agency, such as a bilateral or foundation, to provide preliminary capacity development and potentially grant finance for a representative-scale demonstration of a viable pro-poor business model. An alternative would be to pilot PLF as a ‘shadow’ modality to an existing SWAp, particularly where there are one or more donors keen to support the SWAp but unable to join in directly because of procedural constraints. But other options are available. Smaller-scale alternatives may be possible, for example a PLF agreement between a bilateral financing institution or foundation, and one or more medium-sized service providers. In the event that there is sufficient interest, a larger pilot incorporating several service providers, operating at city level, would provide considerably expanded learning opportunities, and the opportunity to reach many more poor urban residents. These latter options would also facilitate the introduction of competition, either in selecting eligible service providers, or in the assessment of progress and award of finance (see Section 4.1).

A natural first step would be to convene a roundtable meeting, with equal representation from interested service providers and financing institutions, to discuss these options in greater detail and agree appropriate formats for piloting PLF.

There are, of course, several provisos. Above all, if PLF is to have traction and make a positive impact in the WASH financing landscape, as well as helping bring basic services to poor urban residents, it must be rooted in political realities. This includes acknowledging what PLF may not be able to achieve. In the case of sanitation, for example, institutional responsibilities in some countries may be so unclear at the municipal level, or even the national level, as to make it difficult to see who a PLF agreement could even be made with. In such situations it may be necessary to postpone PLF and focus on traditional concessional finance and technical assistance to help the lead ministries better articulate their responsibilities, and those of municipalities and other decentralised levels, for the entire sanitation chain. At the same time, this could be used as an opportunity to define and embed the overall pro-poor objectives to which an eventual PLF agreement could subscribe. But even in such cases where bottlenecks to sustainable pro-poor service delivery are deeply rooted in society, politics or law, ambition on the part of both service providers and financing institutions may be very powerful. For example, legislative barriers (like a requirement for land tenure or proof of address) to connect to municipal services including water and sewerage can present an apparently insurmountable obstacle to a sector-specific approach like PLF. Nonetheless, as one respondent argued, the legislative environment in developing country cities may be sufficiently fluid for such requirements to be waived without serious repercussions, as was done by Manila Water in their pro-poor programme (Lynch & Matthews, 2010).

Attention to the reality of designing and implementing PLF has underpinned the analysis of the preceding sections, and recommendations have been made accordingly. The following are the most pertinent messages.

“ Commercial viability of any pro-poor business model must be a central goal of PLF ”

### Defining progress

Key principles for how to establish what progress entails, and the sorts of things which are important, include:

**Consensus and participation:** Who defines progress is critically important. As a default, the key components of a commercially viable pro-poor service delivery model and the relevant reforms and capacity development needs should be defined consensually between service provider, financing institutions and other bodies as necessary. Where separate institutions are responsible for asset management and operations, both must be actively involved.

**Taking a realistic approach to commercial viability:** Commercial viability of any pro-poor business model must be a central goal of PLF, whether at demonstration or city-wide scale. However, commercial viability should be defined in a context specific manner, permitting cross-subsidisation from non-poor areas or more modest thresholds (such as operational cost recovery) as appropriate – particularly for the components of the sanitation chain with strong public-good benefits.

**Integrating SSIPs:** Progress on commercially viable, pro-poor services needs to be defined in terms that recognise and integrate the small-scale independent providers that currently fill the service gap in areas left out by the official provider. Failure to do so will, at best, miss out on the potential contribution of entrepreneurs who have successfully created viable businesses within challenging environments, and at worst, lead to outright conflict with them.

**Defining who is poor:** Capacity to serve poor people, or demonstrating that such services are financially sustainable, rests on accurately identifying where, and who, poor people are. Strengthening the service provider's own ability to distinguish between poor and non-poor unserved is a first priority of any PLF agreement.

**Incorporating the full sanitation chain:** Pro-poor sanitation services are not limited to the provision of low-cost latrines. While the immediate priority should be to safely confine excreta within the immediate domestic environment, the wider issues of collection, treatment and reuse must be addressed within any sanitation business model. This may necessitate PLF agreements incorporating actors beyond the nominated lead service provider – including those responsible for drainage and general urban planning, as well as SSIPs.

**Choosing service levels appropriately:** Any pro-poor WASH service delivery business model should provide services that are cost-effective, but demand, health and convenience should also play a role in selecting appropriate technologies and service levels. Where service levels are higher, ways should be found to reduce or spread the cost to the low-income consumer – for example through connection subsidies or revolving funds.

**Designing flexible payment systems:** Pro-poor WASH requires recognising that it is not only the cost of services which is a barrier to poor people, but the way in which those costs are normally recovered. A pro-poor business model should find solutions where low-income groups struggle to make regular payments, potentially by involving regulated SSIPs as intermediaries for supply and/ or revenue collection.

**Incentivising throughout the organisation:** A deep cultural shift may be required for some service providers to recognise the untapped potential customer base in low-income areas. In addition to the organisation-wide incentive presented by Progress-Linked Finance, staff-level incentive structures, including bonuses, may need to be developed to stimulate that shift.

**Enhancing upward and downward accountability:** The relationship established between financing institution and service provider through a PLF agreement should strengthen, rather than detract from, accountability between customer and service provider, and service provider and government.

“ PLF should aim to strengthen local systems for the collection of data ”

### Linking finance to progress

Recommendations relating to the institutional and procedural arrangements for a PLF agreement and associated support and verification:

**Piloting PLF within a wider infrastructure project, parallel to a SWAp, or a more ambitious multi-service provider arrangement:** As mentioned above, there are various options for piloting PLF, depending on ambition and expedience. For example, piloting PLF as component within a broader infrastructure project could facilitate upstream reforms involving a broader range of urban and government stakeholders beyond the service provider, while allowing the PLF agreement to focus specifically on pro-poor aspects of the service provider's activities. If sufficient interest and funds could be found to pilot PLF with several different service providers in parallel, the beneficiaries would be increased commensurately but more importantly, so would the lessons for institutionalising PLF as an approach applicable to multiple contexts and the very different needs of water, sanitation and hygiene provision.

**Institutionalising PLF within a trust fund:** In the long term, a trust-fund is likely to be the natural arrangement in which to house PLF – effectively allowing finance to be committed over longer time-frames and potentially overcoming individual financing institutions' procedural restrictions. In countries with a sufficient diversity of service providers, a trust fund could also be established at national level. Whether at international or national level, such a fund could operate on 'challenge' principles, whereby proposals for Progress-Linked Finance are invited from eligible service providers and evaluated competitively, or where multiple service providers compete for different levels of finance, dependent on the progress they achieve (the 'bronze-silver-gold' concept mentioned in Section 4.1).

**Enforcement – balancing incentive with practicality:** Whatever the institutional architecture for PLF, expectations must be clear for all parties. While enforcement of the thresholds for progress should be sufficiently strict to create a meaningful incentive, some room for negotiation may be a practical necessity for both service providers and financing institutions.

**Matching support to needs:** The capacity development needs of service providers will vary enormously, as well as being intimately related to the agreed components of progress on financially sustainable, pro-poor services. Similarly, different contexts will suit different institutional arrangements for delivering support. A wide range of approaches and mechanisms for assessing and delivering capacity development, from shadow credit ratings to operator partnerships, to performance-linked contracts, should be considered in each context.

**Verifying through local systems where possible:** PLF should aim to utilise and strengthen local systems for the collection of data, especially those of the service provider, in order to enhance accountability and monitoring and evaluation capacity, whilst also minimising costs. Consulting users themselves, for example through customer satisfaction surveys, will also play an important part in assessing progress. At the same time, verification of a sample of results, by an authority independent of either service provider or financing institution, will be required.

“ A ‘bronze-silver-gold’ system may make PLF more attractive to service providers ”

### Financing progress

Recommendations on the sourcing, sequencing and using progress-linked finance:

**Sourcing funding – persistence and flexibility:** If a decision is made to take the PLF concept forward, proponents may have to invest considerable effort in securing finance, especially for the relatively high costs associated with infrastructure investment (including grant finance for ‘representative-scale’ demonstration). This undertaking could be strengthened by:

- casting the net widely across traditional/non-traditional and international/domestic sources of finance;
- maximising the synergies between different sources of finance;

**Using the terms of funding to magnify incentives:** As well as the overall amount of funding involved, the terms on which finance is tied to progress may be used to incentivise further change: for example, by awarding some finance on a bonus basis for incrementally higher progress beyond a certain threshold. Allocating a certain baseline amount of finance on a non-conditional basis, or offering a minimum ‘bronze’ level of finance under a ‘bronze-silver-gold’ system, may also make the PLF concept more attractive to service providers by guaranteeing a predictable, basic level of funding.

**Permitting service providers some discretion in how they spend finance awarded at the end of a PLF process:** While most finance awarded at the end of a PLF process will need to be earmarked for extending the network to low-income areas and connecting low-income households, there are arguments for permitting the service provider a degree of discretion in how a remaining portion is used.

**Using PLF to leverage other sources of finance:** An alternative to awarding concessional finance for scale-up at the end of a PLF process, would be to use the progress achieved as a platform to seek commercial credit or patient capital. While potential options have been considered in this report, establishing feasibility requires further exploration with experts in commercial and social finance.

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## Appendix 1: Potential pro-poor indicators

Diverse types of indicator could form the basis for PLF agreements. One interesting approach is that being developed by the UNESCO-IHE PROBE project (Blokland, 2011). While PLF would probably require something simpler, the wealth of thinking already undertaken for this project could provide a strong basis for devising a list from which PLF partners could select context-relevant indicators for pro-poor progress. At the apex of the PROBE indicator set hierarchy are broad 'perspectives', each of which is assigned a number of 'indicators' (the bullet points), which are themselves composite metrics scored according to a several 'criteria' (sub indicators).

### Policies and capacities

- Political initiative and support
- Capacity of LGO/Regulator
- Capacity of WSS providers

### Collaboration

- Inter agency collaboration
- End user or Community participation

### Tools

- Mapping the poor
- Pro-poor financial instruments
- Pro-poor technology
- Pro-poor incentives

### Sustainability

- Innovation and learning
- Durability

### Services provision

- Quality of pro-poor sanitation services
- Quality of pro-poor water services

As examples, the largely quantitative/ output indicator for 'Quality of pro-poor water services' is scored against the following criteria:

- Technology: supply from standpipes %
- Convenience: distance from home/water use m/lpcd
- User appreciation: water quality is good %
- Continuity: Recurrence interval/duration of supply interruptions day/hr
- Water procured from: vendor/utility/NGO %
- User consultation: in development/implementation/M&E%
- Population coverage and supply (%/lpcd)
- Supply hours (hr/day)
- Water quality compliance (chlorine residual)
- Customer satisfaction (qualitative)

... while the more qualitative/ process indicator for 'Political initiative and support' is assessed against the questions:

- Is there a pro poor WSS policy?
- Is there any specific pro poor water and sanitation legislation and/or regulation?
- Are there specific targets and programs for the provision of pro-poor water and sanitation services?
- Are there significant financial allocations for pro-poor water and sanitation provision from the central/local government?
- Are there specific organisational arrangements in place for pro-poor water and sanitation services in central/local government?
- Has the government taken initiatives to create and support multistakeholder forums or established any other organisational arrangement to enable stakeholders to engage in pro poor WSS provision?

... finally, the answer to these questions appears to be established against a number of criteria, e.g. for the question 'Is there a pro poor WSS policy?':

- Elaborates priority to WSS services provision to the poor
- Has a component on water supply and sanitation services provision to the poor
- Has community participation and gender components
- Includes financing mechanism for pro-poor WSS services provision

The Performance Assessment System (PAS) Project in Gujarat and Maharashtra states (Mehta, 2011) has supplemented a list of more conventional key performance indicators with a 'Framework for Equity Assessment':

### **Enabling Environment**

- Presence of a positive policy to provide services to the poor
- Affordable Tariffs for access to services, options to pay in instalments
- Efforts to include 'non-notified' slums
- Inclusion of slums houses under property tax
- Special national/ state schemes for services in slums

### **Local Preparedness**

- Extent of funding (%) in local budgets for the poor and in slum areas
- Efforts made to improve/ simplify connections in slum settlements
- Presence of internal network (water supply, drainage) in slum settlements to facilitate ease and affordability in access

### **Service Delivery**

- Access to basic services for water and sanitation in slum areas (JMP definition), extent of open defecation
- Access to on-premise facilities for water (municipal connection) and sanitation (toilet, sewerage connection, door-to-door SWM)
- Quality of service delivery (quantity of water, pressure, timing, etc.)
- Complaint redressal for the poor

Though on the subject of regulation, OBA Working Paper No. 8, Regulation of water and sanitation services: Getting better service to poor people by Trémolet and Halpern (2006) provides a useful list of questions which could be used to stimulate the development of indicators:

### Regulating access expansion

- Do service providers have sufficient incentives to expand coverage?
- Is the definition of coverage appropriate or does it limit service solutions?
- Is adequate funding in place for expanding coverage?
- Does the regulator have all necessary tools and instruments to regulate the main provider's coverage targets?

### Regulating tariffs

- Do tariff setting principles emphasize the need to take account of poor customers? Do they define concepts such as "equity" or cost-recovery sufficiently clearly? How are they interpreted?
- Do tariff structures target subsidies to poor consumers?
- If an IBT is in place, what is the size of the first-block?
- Do higher blocks recoup the subsidies provided in the initial blocks?
- Are subsidies available to all or are they targeted on the poor?
- Is there a specific tariff for standpipes or bulk sales?
- What is the charge for a new connection and can poor customers afford it?
- If there is a "social connection" policy and do the criteria allow the poorest to benefit?

### Regulating service quality

- Are quality objectives set at an appropriate standard to meet the needs of the poor? Do service providers have any flexibility to adapt service quality to those needs?
- Are there appropriate quality monitoring mechanisms in place to monitor service quality in poor areas so as to ensure that service providers do not sacrifice quality in those areas?

### Regulating alternative service providers

- Does the main provider have exclusivity, either explicitly or implicitly (e.g. monopoly over abstraction rights)?
- Do alternative providers represent a large share of the market? What are the characteristics of the alternative provider market? Do they provide adequate services and could they be developed to cover broader areas?
- Is the existence of alternative service providers officially recognized? Does the regulator have the remit and the ability to regulate them? If it is not responsible to regulate them, would it be appropriate for the regulator to play a role in this area? Does the regulator have contacts with alternative providers?
- Do alternative providers have the ability to compete on a level playing ground (e.g. are bulk water selling rules equitable)?
- Is there any "light regulation" of alternative providers (such as publication of information, simplified licenses, service provider associations, etc)?
- What are the aspects of their activities which are not currently regulated and should be (prices, service quality or customer relations)?
- Does the regulator have all necessary tools and instruments to monitor and regulate alternative providers or should it develop additional tools?
- Do existing rules give alternative providers incentives to expand?
- What could be the role of main provider (s) for regulating small-scale providers?
- What other mechanisms for regulating alternative providers (such as association of providers, etc...) exist already or could be initiated?

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