Small Utility Access to Market Credit: Lessons and Options

SWIF Project – Component 3

Completion Assessment Report

December 2008

Information and Acknowledgments

December 2008

This report is one of the deliverables under the Component 3 of the Small Water Utilities Improvement and Financing (SWIF) Project implemented by the Water and Sanitation Program (WSP) of the World Bank. SWIF aims to improve the ability of small utilities to access increasingly market-based financing in line with the Government of the Philippines' water sector financing strategy. Component 3, co-financed by the Public-Private Infrastructure Advisory Facility (PPIAF) Sub-National Technical Assistance, seeks to examine issues surrounding access to market-based financing by small water utilities towards developing an intervention program.

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The Water and Sanitation Program (WSP) is an international partnership to help poor people gain sustained access to improved water supply and sanitation services. The Program works with partners at the country, regional and international levels. It assists countries to build their capacity, reform policies, strengthen institutions and develop human resources. It also supports sustainable investments, learns what works and what does not work and why, and disseminates lessons of experience within countries and internationally.

WSP has four regional offices in Africa, Latin America, South Asia and East Asia & the Pacific (EAP). WSP-EAP operates through a regional office in Jakarta, Indonesia, with additional offices in Cambodia, Laos, the Philippines, and Vietnam.

Acronyms

AUSAID	Australian Agency for International Development
BAP	Bankers Association of the Philippines
BCM	Billion Cubic Meters
BSP	*Bangko Sentral ng Pilipinas* or Central Bank of the Philippines
BWSA	Barangay Water and Sanitation Association
CBO	Community Based Organization
CDA	Cooperative Development Authority
CPC	Certificate of Public Convenience
CPCN	Certificate of Public Convenience and Necessity
DAR	Department of Agrarian Reform
DBM	Department of Budget and Management
DBP	Development Bank of the Philippines
DILG	Department of the Interior and Local Government
DOF	Department of Finance
DPWH	Department of Public Works and Highways
EO	Executive Order
GFI	Government Financial Institution
GOCC	Government Owned and Controlled Corporation
GOP	Government of the Philippines
HOA	Home Owners Association
IDA	International Development Association
IHAP	Investment Houses Association of the Philippines
IRA	Internal Revenue Allotment
IRR	Implementing Rules and Regulations
KALAHI	Kapit-Bisig Laban sa Kahirapan- Comprehensive and Integrated Delivery of Social Services.
LBP	Land Bank of the Philippines
LGC	Local Government Code
LGU	Local Government Unit
LGUGC	LGU Guaranty Corporation
LWUA	Local Water Utilities Administration
MDFO	Municipal Development Fund Office
MDG	Millennium Development Goals
MWSS	Metropolitan Waterworks and Sewerage System
NAPC	National Anti-Poverty Commission
NAWASA	National Water and Sanitation Authority
NEDA	National Economic and Development Authority
NRW	Non-Revenue Water

NSO	National Statistics Office
NWRB	National Water Resources Board
NWRC	National Water Resources Council
ODA	Overseas Development Assistance
OECD	Organization for Economic Co-operation and Development
PAFCI	Philippine Association of Finance Companies
PD	Presidential Decree
PDAF	Countryside Development Funds
PFI	Private Financial Institution
PPIAF	Public Private Infrastructure Advisory Facility
PPP	Public Private Partnership
PRG	Partial Risk Guarantee
PSP	Private Sector Participation
RA	Republic Act
RWSA	Rural Waterworks and Sanitation Association
SEC	Securities and Exchange Commission
SWIF	Small Water Utilities Improvement and Financing Project
SWU	Small Water Utility
UNICEF	United Nations Children's Fund
USAID	United States Agency for International Development
WD	Water District
WHO	World Health Organization
WSP	Water and Sanitation Program
WSPs	Water Service Providers
WSS	Water Supply and Sanitation

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I. Introduction

a. Background

1. The Small Water Utilities Improvement and Financing Project (SWIF) aims to improve the performance and financial viability of small utilities and support them to increasingly access market-based financing in line with the Philippines water sector financing policy, embedded in Executive Order 279 of 2004. It is implemented by a multi-agency technical working group composed of the National Water Resources Board, Local Water Utilities Administration, Department of the Interior and Local Government and the Cooperative Development Authority under the direction of the Department of Finance, with support from the Water and Sanitation Program - Philippines (WSP Philippines) of the World Bank.

2. Component 3, which is co-financed by the Public-Private Infrastructure Advisory Facility (PPIAF) Sub-National TA, seeks to examine issues surrounding access to market-based financing by small water utilities towards developing an intervention program. At inception in 2008, a rapid assessment looked at the systematic constraints and opportunities for increasing the success of transactions between private financial institutions and small-sized[1] water enterprises. The assessment identified key constraints to small water utility access to finance, summarized here in Annex 1. Most of the constraints identified in the rapid assessment are addressed by interventions on financial structuring not planned within the timeframe of SWIF.

b. Objectives and Methodology

3. This Completion Assessment Report aims to lay the basis for stakeholders, primarily, the Government of the Philippines through the Department of Finance, to consider a follow-up intervention. The report identifies issues that currently impede the flow of loan finance from private financial institutions (PFI) to small water utilities (SWUs) and proposes initiatives and/or financial products that might encourage the flow of capital from the former to the latter. Hence, its terms of reference intended the report to be specific enough as to provide government with a basis for introducing initiatives that would encourage lending to this sub-sector.

4. The report draws from the findings and observations of earlier reports commissioned under SWIF. Information gathered to support the report is largely a result of in-person and telephone interviews with individuals connected with institutions deemed to be relevant to this purpose. While the format of these discussions were unstructured, the main elements and focal points of discussion were consistent from one discussion to another, based on a predetermined list of talking points designed to enhance discussion.

[1] A 'small utility' is defined as a piped water service provider with less than 5,000 house connections.

c. Participating Water Utilities

5. There are 11 water utilities participating in the SWIF: six local government-owned (LGU-operated) utilities; four community-owned (Cooperatives) and one Rural Waterworks and Sanitation Association (RWSA). Two of the water utilities are located in Luzon, three in the Visayas and six in Mindanao. The list of water utilities is shown in Table 1, below.

Table 1. Water Utilities Participating in the SWIF Project[2]

No.	Utility	Type	Location
	LUZON		
1	Buhi Rural Waterworks and Sanitation Multipurpose Cooperative	Cooperative	Buhi, Camarines Sur
2	Darasa Rural Waterworks and Sanitation Association	RWSA	Barangay Darasa, Tanauan City, Batangas
	VISAYAS		
3	Antequera Waterworks System	LGU Utility	Antequera, Bohol
4	Tagbilaran City Waterworks System	LGU Utility	Tagbilaran City, Bohol
5	San Carlos City Waterworks System	LGU Utility	San Carlos City, Negros Occidental
	MINDANAO		
6	Calamba Municipal Waterworks System	LGU Utility	Calamba, Misamis Occidental
7	Initao Waterworks System	LGU Utility	Initao, Misamis Oriental
8	Medina Rural Waterworks and Sanitation Multipurpose Cooperative	Cooperative	Medina, Misamis Oriental
9	Maragusan Rural Waterworks and Sanitation Multipurpose Cooperative	Cooperative	Maragusan, Compostela Valley
10	Santo Tomas Waterworks System	LGU Utility	Santo Tomas, Davao del Norte
11	Padada Waterworks Multipurpose Cooperative	Cooperative	Padada, Davao del Sur

2 Water Supply and Sanitation Performance Enhancement Project (GoP,WSP East Asia and the Pacific World Bank, AusAID). December 2005. *Philippines Small Towns Water Utilities Data. Benchmarking of Small Towns Water Utilities in the Philippines*. Philippines

II. Overview of the Water Sector

a. Water Sector Coverage

6. Under the Millennium Development Goals (MDG), the Government of the Philippines has established a target to achieve 86.5% water service connection by 2015.

7. However, with the rapid growth in population, the demand for water continues to rise. At a rate of 2.11% increase per year, the population is expected to reach approximately 103 million in 2015[3]. Currently there are 81 million Filipinos distributed in over 136 cities, 1,495 municipalities and 82 provinces. Domestic demand for water was projected to be 1.95 BCM/year in 1995 and is expected to increase to 7.43 BCM by 2025. More critically, however water for agricultural use was projected to be 25.53 BCM in 1995 and 72.92 in 2025[4]. The 1998 NWRB Master Plan Study on Water Resource Management further states that 9 major cities (Metro Manila, Cebu, Davao, Baguio, Angeles, Bacolod, Iloilo, Cagayan de Oro and Zamboanga) will experience critical water needs by 2025.

8. Since the Philippines Water Supply Sector is made up of various types of service providers which co-exist and operate under different regulatory and financing schemes, there is difficulty in obtaining coverage and population access to safe drinking water and sanitation. The Philippine Water Supply Sector Roadmap (2005) notes that weak monitoring systems make it difficult to ascertain accurately the extent of water supply coverage and population access to safe drinking water and sanitation services.

9. According to the United Nations' WHO and UNICEF Joint Monitoring Program, urban access to improved drinking water sources declined from 95% in 1990 to only 87% in 2004. However, rural coverage increased slightly from 80% in 1990 to 82% in 2004[5]. The National Statistics Office reports that about 80% of the population has access to improved water supply in 2004. The National Statistics and Coordination Board Report on the MDGs estimate about 45% of those with improved water service enjoy piped connections, or Level III.

b. Number of Water Service Providers that are "Small"

10. A key objective of this report is to attempt to identify the financing needs of SWUs and to determine what kind of approach is needed to improve their access to capital from PFIs. Our first task, then, is to identify the SWU universe, so we are better aware of the sheer numbers and types of utilities with which we are dealing. We note the existing categorization systems of water service utilities advanced by LWUA and the National Water Resources Board (NWRB). Utilities that do not fall under the regulatory purview of LWUA or NWRB do not have any formal categorization system that defines size. Thus, for the purpose of this report, then, we have simply defined SWUs as those with less than 5,000 connections.

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[3] National Statistic Coordination Board Report for MDGs (2004).
[4] Department of the Interior and Local Government – Water Supply and Sanitation Program Management Office, compiled 2008, Draft Philippine Water Supply Sector Roadmap.
[5] World Health Organization / UNICEF, Updated June 2006, Joint Monitoring Programme for Water Supply and Sanitation – Coverage Estimates of Improved Drinking Water, Philippines.

11. Categorization by LWUA. The Local Water Utilities Administration (LWUA), which is responsible for providing technical assistance to the water district utilities (one of six types of utilities we will be discussing further below), has a categorization system in place. LWUA developed the Manual on Categorization and Re-categorization to formally determine the "size" of water districts. A point-system is used to identify whether a utility is small, average, medium, big, large and very large. Factors considered in the initial categorization of a water district include gross receipts, number of personnel, number of service connections, nature of operation, total fixed assets and net income before depreciation and interest. Corresponding weights are then applied to these factors to derive the utility's size. A utility may also apply for a re-categorization of its current size, in which case, guidelines are also presented in the Manual. We have taken the 2007 data of LWUA and identified those utilities with under 5,000 connections.

12. NWRB Categorization. NWRB also provides a process for the categorization of utilities. Water utilities regulated by NWRB are placed into one of 3 categories: small, medium, and large. Given the diversity of utilities regulated by the NWRB, categorization has been derived by attaching weights to two key factors: (i) number of service connections and (ii) gross water sales, with a weighting of 40% and 60% respectively. Since gross water sales represents water produced and sold, it provides a better indication of the utility's volume of operations and, hence, a higher weight is given to this factor over the number of service connections. Based on the approach, the utility is given a rating of 1, 2 or 3, with 1 being the largest in terms of weighted criteria. To date, however, the categorization by NWRB has not yet been implemented.

13. Several types of water service providers exist in the Philippines and the more organized and formal ones are the following:

- Water Districts,
- Privately-owned and operated utilities
- Local Government Unit (LGU)-owned and managed utilities
- Community-based water supply, including
  - Cooperatives
  - Rural Waterworks and Sanitation Associations
  - Barangay Waterworks and Sanitation Associations
  - Home Owners' Associations

14. Water Districts. Water districts, the first of four categories, are Government-owned and Controlled Corporations (GOCC), with board members, management and staff subject to civil service rules, government compensation policies, and auditing rules. The latter are established through the initiative of an LGU with the assistance of LWUA, which specializes in the development of water utilities in part by providing loans.

15. A water district is considered a local corporate entity licensed to operate a water supply system in a province, or one or several cities and municipalities. A formal recognition as a water district entitles the latter to technical support and financing from LWUA. At present, and as we discuss further below, there are 594 water districts in the Philippines covering 40% of the municipalities and 80% of the cities.

16. Table 3 summarizes the number of water districts by categories, operating status and geographic location. Some 475 of these water districts are operational and about 60% of these are categorized as 'small' based on LWUA categorization.

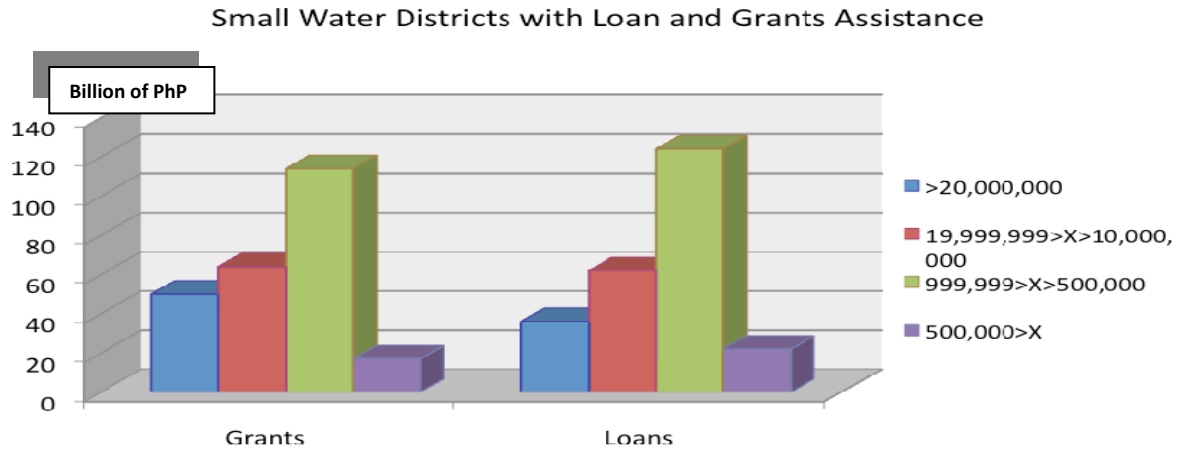
Table 2. Summary of Water Districts by Category, Geography and Status

Water District Category	Luzon	Visayas	Mindanao	Total
Small	150	70	63	**283**
Average	27	10	13	**50**
Medium	35	18	9	**62**
Big	41	1	12	**54**
Large	12	4	2	**18**
Very Large	3	3	2	**8**
Total operational water districts	268	106	101	**475**
Non-operational water districts	63	32	24	**119**
Grand Total	**331**	**138**	**125**	**594**

17. Ninety-six percent (96%) of these water districts have operational status while the rest are classified as non-operational. The latter are entities that do not have a Governing Board or a license to operate having been denied financing by the LWUA after being determined "nonviable" according to LWUA standards.

18. It is interesting to note that of the total 283 operational small water districts, ninety-five percent have been granted loans and approximately the same number have been provided grants by the LWUA. Majority of these loans and grants range between P0.5M and P1.0M, as shown in Figure 1. As of December 2007, water districts categorized as small provided 303,025 service connections or 10% of the aggregate connections achieved by all water districts.

Figure 1



19. Privately-operated utilities. Privately operated utilities, by definition, include all publicly- and privately-owned water utilities that are currently being managed by a private operator under various PSP schemes. Two of these systems are in Metro Manila and are operated under concession agreements since 1997. Three (3) others operate as public-private joint ventures in Tagbilaran, Subic Bay and Clark Area in

Pampanga. A total of 9 water systems fall into this category. Five of the nine systems have less than 5,000 connections. Most private operators, as is the case with water districts, provide level III services. An excellent example of a privately-owned and operated water utility is the Balibago Waterworks.

20. LGU-operated water utilities. Under the Local Government Code, the LGU has responsibility of providing potable water to its constituents. It has the option of organizing its water service as a water district or operating its own utility through its municipal engineering or city administration department. Typically, a water utility is operated alongside other economic enterprises such as markets, bus terminals, and slaughterhouses and competes for financial resources with these organizations. As noted in other studies, LGU-operated utilities are heavily politicized entities, subject to considerable political interference and heavily dependent on subsidies for their financial sustainability because of their inability to charge reasonable tariffs. Operating expenditures are recovered partially from water tariffs, while funding for capital improvements are sourced from loans obtained by the LGU from the national government through the Municipal Development Fund Office (MDFO) of the Department of Finance (DOF) or, directly, from government financing institutions such as the Development Bank of the Philippines (DBP) and the Land Bank of the Philippines (LBP).

21. The LGU-operated utilities face relatively larger problems in accessing financing - whether from public or private sources. Since they operate within the ambit of the local government, they will compete for resources with other departments. This usually results in insufficient funds to operate efficiently or inability to expand services. If they attempt to access private funds, they are faced with less, or no, interest from PFIs, partly because of their political nature. These SWUs are most numerous and appear to have the greatest needs.

22. As there is limited data on the existing number of LGU-operated utilities, the following table attempts to estimate their numbers by taking the whole universe of LGUs and deducting from the total, (a) LGUs supplied by water districts and private service providers; and (b) an additional estimate of 15% of the total LGUs that are assumed to be served by other types of water utilities. Table 3 describes this approach. As shown in our Table, there are 1,495 municipalities in the Philippines and 136 cities for a total of 1,631 LGUs. From this total, we deduct the number of water districts and the local governments falling within the service of metro-wide water districts (702), as well as the number of local governments service by private utilities (24). We deducted 245 other LGUs that are assumed to have alternative service providers (15% of the total LGUs) to arrive at an estimated 660 LGU-operated utilities. Obviously, the estimate is tenuous at best and can only be regarded as a working hypothesis.

Table 3. Estimating the Number of LGU-Operated Utilities

	No.	%
Municipalities	1,495	
Cities	136	
Total	**1,631**	**100%**
Less: Water Districts, including non-operational	(594)	43%
LGUs additionally covered by metrowide WDs	(108)	
LGUs in Metro Manila (private companies)	(17)	2%
Other LGUs served by private companies	(7)	
Other Service Providers	(245)	15%
LGU-Operated Utilities	**660**	**40%**

23. Cooperatives, Homeowners Associations (HOA) and Other Privately Owned and Managed Utilities. Water service providers that are organized as cooperatives, HOA or other privately-operated utilities are not government-owned or controlled in any aspect. Hence, these utilities have limited, or no, access to public financing institutions. These organizations are generally very receptive to private financing and, one would think, attractive to private financiers. However, the diffused ownership of cooperatives and associations, in addition to their style of organization is not attractive to PFIs, a factor discussed later in this report.

24. Based on records of the NWRB, there are about 400 of these cooperative utilities with the great majority being very small. It is quite difficult to assess the requirements they may have for funding, unless a more in depth study is conducted with detailed surveys that focus on their funding needs.

25. Others. Still other water service companies operate through community-based organizations (CBOs) and associations such as the Barangay Water and Sanitation Association (BWSA), and the Rural Waterworks and Sanitation Associations (RWSA). All BWSA and RWSA can be classified as SWUs.

c. Requirements for Expansion Capital

26. General Requirements for Term Finance. With the implementation of EO 279 and its objectives, examined in detail further below, the water districts, including the small water districts, are projected to have better access to financing than LGU-operated water utilities. LWUA is directed under EO 279, discussed further below, to graduate the already creditworthy water districts and focus on the development of those that remain questionable, which in most cases are the smaller water districts. As a water utility grows in terms of service connections, so does its earning capacity and, in general, its creditworthiness. A World Bank report recently estimated that at least P 80.0 billion will be needed by those less credit worthy water districts (all categories included) over the period 2007 to 2013 for improvement and expansion purposes. It is however difficult to establish how much of the credit demand would be required by the SWU component within this group.

27. To address this question of capital requirements for SWUs, we employed a makeshift methodology that estimates the credit requirements of the entire sector for the period up to 2015, based on a benchmark demand that is aligned to the Millennium Development Goals (MDG).

28. According to the MDG, the Government of the Philippines (GOP) has pledged to connect 86.5% of its population to improved water sources by 2015. Currently, as discussed earlier in paragraph 9, we assume that around 80% of the population has access to improved water supply. Given this statistic, the shortfall can be defined by the difference between 86.5% (the 2015 target) of the population in 2015 and the current coverage of 80% of the population as of 2008 (approximately 64.8 million people).

29. Based on the National Statistics Coordination Board projections, the population of the Philippines would stand at 103 million by 2015. This would represent a requirement to provide improved water service for 89 million, based on the 86.5% MDG pledge. If we assume that the same portion of people will have access to piped water as there is currently (45%), then the pledge would require investment in

piped water supply for roughly 40 million people, or an addition of 4 million people from the present 36 million with access to piped water.

30. A widely accepted estimate is that it takes about US$200/capita to create a piped water system (excluding sanitation). Assuming water service capacity is barely meeting demand currently, it would appear justifiable to estimate investment needs at about $2.6 billion for new network capacity over the next 7 years. This is a rough estimate that does not take into account investment in the *existing network* for reinforcement, reduction of NRW, investment in improved energy efficiency or any number of other requirements. It also excludes upgrades in water provision such as improving Level 1 and 2 water supply to Level 3. Hence, the number identified is grossly conservative.

31. The principle objective in attempting to determine the numeric presence of SWU in each of the 6 categories of water utilities was to estimate their relative importance in the network expansion that is assumed to be needed if the government is to meet its MDG pledge. Based on the analysis on paragraphs 16-28, it appears justified to believe that the SWU could easily account for 50-60% of this investment requirement, suggestive of a range of US$400 to 480 million (PhP 19.0 – 23.0 billion) at today's prices. The investment requirements for new network expansion could easily exceed PhP 40 billion, taking inflation into account, and might surpass PhP 80 billion if investments in the improvement of the existing network, or in new sanitation facilities, were to be taken into account. It would appear that PFIs will have to play a key role in providing the debt needed, if this level of investment is roughly accurate. This context, while it may represent very rough estimates of required financing, provides some idea of the potential importance of PFIs over the next few years in meeting the investment requirements of the water sector. Among other matters, it raises the issue of whether the PFIs are interested enough in participating in the water sector's requirements and/or whether the SWUs have the absorptive capacity to handle the debt requirements. To begin to address this question, we turn to an examination of the regulatory framework in the next Section.

III. Legal and Policy Framework for Water

32. Two national agencies, the National Economic and Development Authority (NEDA) and the National Water Resources Board (NWRB), exercise major sector responsibilities in sector policy, planning, coordination, monitoring and regulation, as discussed below.

a. Overview of Legal and Policy Framework for Water Utilities

33. National Economic and Development Authority (NEDA). NEDA is the central planning agency and has for its mission the following: "… to formulate development plans and ensure that plan implementation achieves the goals of national development." Its mandate comes from several Executive Orders, the most relevant of which is Executive Order No. 230 Reorganizing the National Economic and Development Authority (1987) which states that: "The Authority shall primarily be responsible for formulating, continuing, coordinated and fully integrated social and economic policies, plans and

programs… including the formulation of annual and medium term public investment programs…and the monitoring and evaluation of plan implementation."[6]

34. In the water supply sector, NEDA defines the institutional roles and responsibilities of sector agencies, and sets broad coverage targets for the country, defines broad policies particularly regarding access of low income groups to services, cost recovery to support sustainability, incentives to improve operational efficiency and mechanisms for private sector involvement.

35. In the area of planning and monitoring, NEDA consolidates reports from various agencies to prepare the Medium Term Philippine Development Plan which shows the status, plans and strategies for the sector.

36. **National Water Resources Board (NWRB)**. The NWRB as presently constituted, performs two (2) regulatory functions i.e. a) water resource regulation and b) economic regulation of water services. NWRB's role as the **water resource regulator** can be traced to the National Water Resource Council (NWRC) which was created by Presidential Decree No. 424 on March 28, 1974. The NWRC was tasked to coordinate and integrate all activities related to water resources development and management. On December 31, 1976, the Water Code (Presidential Decree No. 1067) was promulgated with the following objectives:

a. To improve and rationalize management of water resources

b. To allow use and development of waters by administrative concessions

c. To regulate and control utilization, exploitation, development, conservation and protection of all water resources

36. Republic Act No. 9275, or the Clean Water Act, vested in the NWRC (now NWRB) the task to implement the Water Code.

37. As to its role as the **economic regulator** of water services of private water utilities, the powers and functions of the NWRB, as such, can be traced back to the Public Service Commission created under Commonwealth Act No. 146 [1936], as amended. In 1972, the Integrated Reorganization Plan abolished the Commission, and its adjudicatory and regulatory functions over water supply services were transferred to the Board of Power and Waterworks.

38. Under Presidential Decree 1206 [1977], the powers and functions of the Board of Power and Waterworks were transferred to the National Water Resources Council. Accordingly, the Council was vested with power to control, regulate and supervise waterworks utilities systems, specifically, to:

a. Adjudicate and grant CPC/CPCN to applicant/ operator of waterworks utility systems and services;

b. Impose penalties for administrative violations and promulgate rules and regulations relative thereto;

[6] NEDA website

c. Supervise and control all waterworks utilities and their franchises and other properties; regulate and fix water rates to be charged by waterworks operators, except those falling under the jurisdiction of the MWSS and LWUA and water districts;

d. Exercise original jurisdiction over all disputes relating to water rates of waterworks utilities except on water rate cases involving MWSS and LWUA (which are however, appealable to the NWRC under PD 198 as amended);

e. To impose and collect Annual Supervision Regulation fees or charges from waterworks system and public utility operators pursuant to Commonwealth Act No. 146 as amended.

39. Executive Order 124 was issued on January 30, 1987 renaming the NWRC to the National Water Resource Board.

40. On September 12, 2002, Executive Order No. 123 was issued changing the composition of NWRB, transferred the Chairmanship of the Board from the Department of Public Works and Highways to the Department of Environment and Natural Resources. The NWRB was tasked to review and amend the Implementing Rules and Regulation (IRR) of the Water Code, to formulate new or revised organization structure for the NWRB Secretariat and to regulate water tariffs of Water Districts except to those where Local Water Utilities Administration (LWUA) has financial exposure.

41. Other Key Players. Other agencies in the sector are the (i) Department of Finance (DOF), Department of Budget and Management (DBM) and the Department of the Interior and Local Government (DILG).

42. The **DOF** sets and implements policies on the use of grants and guarantees from national government and official development assistance (ODA). Under its office is the Municipal Development Fund Office which is a Special Revolving Fund created on March 29, 1984 under Presidential Decree No. 1914. The Municipal Development Fund (MDF) aims to establish an effective mechanism that would enable local government units (LGUs) to avail funds from local and international assistance for the implementation of various social and economic development projects.

43. The **DBM** created under Executive Order No. 21, dated April 25, 1936, is mandated under this Order, and by subsequent issuances, to promote the sound, efficient and effective management and utilization of government resources (i.e., technological, manpower, physical and financial) as an instrument in the achievement of national socioeconomic and political development goals.

44. The **DILG** helps enable the capacity building of LGU-operated water utilities by facilitating the implementation of water supply projects that cater to the LGUs. It has a special project management office that identifies necessary water supply projects and activities for LGUs; they also assist in project preparation and packaging and in the eventual implementation of these projects.

45. **National Level – Sector Development, Expansion and Investments**. There are two principal authorities in charge of water services, the MWSS that addresses water needs in the national capital region, and the LWUA, a specialized lending institution that institutes and supports the establishment of water districts in provinces and other urban centers/metro areas. As a specialized lending institution,

LWUA works for the creation and financing of water districts in provincial urban centers outside Metro Manila. In addition it provides technical advisory services to the formed WDs encouraging them to acquire, install, improve, operate and maintain waterworks system for domestic and industrial use, as well as to set up services for the collection and treatment of wastewater within their areas of operation.

46. For areas outside Metro Manila, investments flow to the water sector through **LWUA- or DILG-**led ODA programs and water district or LGU-led initiatives to either, (i) self finance expansion through equity or IRA; or (ii) loan finance expansion through GFIs. In addition, other investments flow into the sector under special arrangements, complicating the institutional arrangements for financing the sector. The NAPC for instance, has a grant program for waterless communities amounting to P500 million a year. NAPC determines the recipients (municipalities), presumably based on a National Statistics Office (NSO) study and coordinates with the DPWH to implement these in their respective areas. The specific Barangay recipient within the municipality however more often than not is identified based on many considerations, including (and most especially) political affiliation. DAR, through the KALAHI grant program, assists agricultural communities for various projects including water supply through DPWH. The countryside development funds or PDAF are another source of grant funds, usually from Congressmen, which are provided to the recipients either to LWUA, DPWH, water districts, or LGUs.

47. **Local Level Sector Responsibilities**. Based on the local government code, local governments at all administrative levels from province, city municipality and barangay, retain responsibility for policy planning and regulatory functions specific to their jurisdiction. This includes choosing financing and management options, deciding on tariffs, providing investment and funding support and setting performance standards. In practice however, this sometimes results in conflicts between the LGU using the LGC and the water districts using PD 198.

48. DILG initiated the preparation of Provincial Water Supply, Sewerage and Sanitation Sector Plans from 1989 to 1995. But these are outdated and have not been effectively used to trigger the investments required in the countryside.

49. In spite of the LGC, the LGU has not taken charge primarily due to capacity problems. Local politics also play a significant role in the decision-making process in cases where the LGU does take the initiative to develop and manage water supply services in its area.

50. At the LGU level, the vast majority of water providers are established at the *poblacion*, or the main urban center of the municipality composed of a handful of barangays, leaving outer barangays to rely on independent systems. Initiative on developing bulk water sources is sparse. This has proved to be a constraint in providing improved services and integrating markets.

b. E.O. 279 and Small Water Utility Financing

51. E.O. 279 was issued on 2 February 2, 2004. Foremost among its goals were to (i) institute reforms in the financing policies for the water supply and sewerage (WSS) sector and water service providers (WSPs) and (ii) rationalize the organization structure and operations of the Local Water Utilities Administration (LWUA) to support the following reform objectives:

a. Improve investor confidence in the WSS sector;

b. Rationalize the allocation of scarce financial resources in the WSS sector through classification and graduation initiatives;

c. Provide freedom of choice of WSPs in sourcing financing;

d. Increase participation of LGUs, GFIs, and PFIs in the financing of the WSS sector;

e. Stimulate improved service and creation of financial self-sustainability for water service providers;

f. Encourage initiatives aimed at self-sufficiency of water service providers, including, but not limited to, amalgamation, private sector participation, cost-recovery tariffs, and resource pooling;

g. Grant incentives for the improvement and graduation of water service providers;

h. Educate consumers towards the importance of treating water as a scarce economic good; and

i. Establish an independent economic regulator for the water supply and sewerage sector.

58. Graduation Process. Central to EO 279 is the graduation process of water districts, where those districts that have achieved creditworthiness are encouraged to seek finance from private sources. LWUA could then focus on lending to those that have not achieved this status. Following this provision, LWUA has adopted criteria for classifying water districts based on measures of their creditworthiness. These criteria were based on financial and operating indicators.

59. Between 2004 and 2008, major steps were taken to implement the EO and achieve its objectives. This includes the conduct of subsequent studies to incentivize LWUA and the Water Districts to support the graduation process and proposed legislations such as increasing the capitalization of LWUA to support its refocused role in financing. However, progress in the graduation process has not been significant due to a number of reasons. The rationalization plan for LWUA has not yet been implemented; and water districts, fearing the lack of a regulator and mentor, would still prefer to maintain their loans with LWUA. In addition, water districts prefer borrowing from LWUA because of the institutional and technical assistance support they are able to access from LWUA, which the PFIs or GFIs are not able to provide.

IV. Key Issues that Impact on Availability of SWU Credit

a. Legal and organization issues common to SWU

60. Aside from the classification of the players by size, SWUs may be further sub-classified by "Type." The SWUs included in the SWIF sample in paragraph 4 can be broken down into three (3) main types: the Water Districts, Local Government Units or LGU-operated; and the Cooperatives. Each has its distinct character, arising from the legal and regulatory framework from which each is created. These differences extend to the ownership structure, organization, management and regulation of the different types. The basic and fundamental differences would imply that SWU cannot, and should not, be defined as a single "generic" entity, especially for purposes of credit and evaluation. The legal framework creating, governing and regulating LGU's for instance is quite different from that extending to corporations and cooperatives. The legal remedies available to lenders for loans extended to each type

will be different and unique, according to their respective legal profiles. Similarly major criteria used in credit evaluation, such as borrower profiles (legal structure, ownership, organization, credit structure, financial condition, etc.), will be interpreted and evaluated according to the unique characteristics of each type of institution.

b. Regulatory Framework of the Water Sector

61. Of prime importance to a bank in building credit and investment portfolios in any sector would be the efficiency and predictability with which the regulatory framework is working in that sector. This would define the environment and parameters within which they will be able to do business in the sector, and hence determine the "palatability" and "desirability" of doing business there.

62. Much of the water sector has "evolved" over the archipelago into what it is today. This evolution, however, was not a "planned" one, and as a result, whatever regulatory framework exists for the water sector is, to a large extent, shaped by reactive rather than progressive forces. Against this backdrop, the regulatory framework for this sector can generally be described as follows:

a. A lack of clarity about the functions, authorities and responsibilities of the various agencies and institutions involved in the water sector. While many perceive the NWRB to be the super body within this framework, there is tacit admission by the latter that less than 50% of the water supply business in the country is under its supervision and regulation. Furthermore, budget and geographical constraints prevent the NWRB from acquiring the necessary logistics to improve on its coverage and more so, perform its enforcement role to even a minimum level of significance;

b. Ambiguity in the grant of "franchise" to operate. While many assume that this is synonymous to a permit to operate granted by the NWRB, this assumption is not completely accurate: first, because less than the majority of the sector operates within NWRB's supervision; and second, because in certain areas, there are still existing units that operate on the strength of "congressional franchises."

c. Many agencies/institutions/bodies are involved in regulatory matters. The local governments for example, are significantly involved as owners of SWUs; while the Cooperative Development Authority (CDA) has jurisdiction over cooperatives. In addition, there is the Local Water Utilities Authority (LWUA), whose charter and function has been revised and re-defined, and it still being re-defined to this date. And, there is NWRB. Unfortunately, there is no visible coordination between these agencies.

c. Bank Funding/Credit Issues

63. As mentioned in the SWIF 3 Rapid Assessment Report, PFIs are not familiar with the water sector beyond knowing a bit about what the sector does and why it exists. This is because water utilities in the past were largely government-controlled and government-run businesses, and were funded by the government using "soft loan" development funding channeled through the Government Financial Institution (GFIs), such as the Philippine National Bank (PNB), Land Bank of the Philippines (LBP), and the Development Bank of the Philippines (DBP). It was just several years ago when the largest of these, the Metropolitan Waterworks and Sewerage System (MWSS), which held the exclusive water supply

franchise for the whole of Metro Manila, was divided into two major franchise areas and privatized. Hence, PFIs do not possess sufficient competence, or capability, in performing technical and financial evaluations of projects/deals in this particular sector. This non-familiarity with the water sector is a concern repeatedly expressed within PFIs – a factor that surely impedes lending activity.

64. Other factors of major concern to PFIs include the following:

a. Institutional Profiles of the SWUs: As previously mentioned, many SWUs are organized as cooperatives or LGUs. These institutional types are not well known to PFIs, and are not particularly sought after, as potential clientele. By its nature, an LGU is a political entity, and the affairs of an LGU are thus, subject to political will and interference. The "political environment" changes from time to time in an LGU, a factor which creates "uncertainty" and therefore the perception of risk when lending to these institutions. Cooperatives on the other hand, are governed by the Law on Cooperatives and the CDA. Not many of the bank lawyers are familiar with Cooperative Law, and tend to become risk-averse in transactions that involve dealings with them. The structure of cooperatives promotes a diffusion of ownership, responsibility, authority and accountability. This creates considerable uncertainty on the succession and continuity of management and in the entity in itself, since no one is really "in control". The result is an inability or unwillingness to evaluate credit risk.

b. Loan/Credit Criteria. On the demand side, SWUs require longer term funding at reasonable interest rates, preferably fixed. This implies that PFIs would have matching sources of longer-term fund sources, available at reasonable cost, to enable loans at lower or preferred rates to the SWUs.

In this respect, a PFI is different from a GFI. The stakeholder of a GFI is the government, and its existence must obviously be consistent with, and supportive of, the objectives of its stakeholder. While profit may be one of the objectives, there are also government socio-economic objectives that the GFI must support to justify its existence. Because of this, Overseas Development Assistance (ODA) funds are channeled thru the GFIs to reinforce their capabilities to perform socially desirable functions.

As government depositories, their resource base takes on a different profile as compared to the PFI deposit bases - both in terms of cost and volatility. Hence, the means by which a GFI can achieve its profit strategy may be quite different from the circumstances within which a PFI operates to achieve profit objectives.

The following are major areas of consideration for PFIs in determining the "desirability" of establishing loan programs in the water sector:

i. **Account Profitability**. This can be defined as the contribution to the "bottom line" for the PFI - the latter a function of interest rate earnings, average cost of funds and the impact of current account balances maintained by the borrower – net of applicable taxes. The average cost of funds of a PFI is normally a function of many variables, including its capitalization, deposit base, reserve requirements, administrative costs and other such factors. The actual effective cost of funds of one PFI will differ from that of another, based on such variables. This comparison is further magnified when comparing the operating dynamics of a given PFI

with a GFI. In such an analysis, it is reasonable to conclude that the direct cost of market-based or market-sourced funds would be higher than funding made available by captive sources such as government deposits and ODA funds. It is also reasonable to conclude that market-sourced funds are more volatile.

Any loan transaction must result in positive spreads for the PFIs, not only in this sector, but in any other sector that they do business in. Economies of account size also come into play in addressing administrative costs. The smaller the loan, the higher the spread needed to cover the fixed expenses of administering the loan. Large-sized credits can carry lower spreads because administrative expense is absorbed more easily and absolute margins are higher.

ii. **Risk Assessment**. While the risk rating of a potential transaction directly affects the account profitability assessment, it can be considered independently for purposes of discussion here. The *institutional profile risk* was discussed in an earlier portion of the report and is definitely an integral part of the overall risk assessment process. In addition to this, *the security or collateral* of a potential loan account is a major consideration in differentiating acceptable from non-acceptable risks. Existing practices and methods employed by PFIs for assigning collateral values to assets are definite impediments to establishing positive risk evaluation ratings for loans to potential borrowers in the water sector. This is due to the fact that a major portion of the SWU assets are comprised of distribution pipes normally underground. For obvious reasons, a collateral value of 'nil' is given to this type of asset, even if pipes are brand new and form part of the project cost for which the loan is being sought. Hence, potential borrowers from this sector would be hard pressed in complying with collateral coverage ratios imposed by PFIs, in particular. On the other hand, PFIs would find it problematic in justifying "clean" loans in their portfolios (i.e., without collateral), particularly if these impact adversely on capital adequacy calculations.

iii. **Business as usual attitudes.** While the water sector presents new loan and investment potential for the financial sector, the traditional markets within which these PFIs operate, are far from saturated. If traditional markets can offer risk acceptability criteria and profitability hurdle rates for loans and investments made by the PFIs, then the natural tendency would be for them to stick to operating in these "more familiar" sectors, even if these are more competitive. In the absence of any "compelling" reasons to venture into sectors hard pressed in meeting minimum credit standards, PFIs will understandably maintain a posture of "risk aversion".

V. Financial Sector Regulatory Framework

65. The most significant player in the commercial bank sector is the Central Bank or Bangko Sentral ng Pilipinas (BSP), responsible for regulating banks and issuing licenses to quasi-banks. Most of the country's monetary policy, emanating from the Monetary Board, is also implemented by the BSP. The Securities and Exchange Commission (SEC) plays a significant role in the administration and regulation of the quasi-banking business, specifically the issuance of securities. Securities business is a strictly regulated activity, as this involves the solicitation of funds from the public in exchange for "commercial paper" or securities issued by the funds users. Funds sourced from this activity are normally classified as "deposit substitutes".

66. Apart from the government regulation, the financial sector is also regulated through self-policing bodies such as the Bankers Association of the Philippines (BAP), Investment Houses Association of the Philippines (IHAP), Rural Bankers Association of the Philippines, Philippine Association of Finance Companies (PAFCI) and other organizations that operate within the ambit of the capital markets segment of the financial sector.

67. There is, of course, no legal and/or policy framework in place exclusive to, or specifically addressing, the environment in which banks and financial institutions interact or deal with the water supply industry. The existing legal and policy framework(s) applicable to the regulation of financial institutions (FIs) is general and comprehensive in its guidelines regarding prudential lending.

a. Lending Policies of Banks

68. The lending policies of commercial banks stem from requirements imposed by the regulatory bodies. In the case of banks, the rules and regulations imposed by the BSP are designed and implemented to promote optimum operational prudence and conservatism in the banking industry. A comprehensive description of these requirements is contained in a Banking Regulations Manual issued by the BSP to all banks. A separate manual for quasi-banking activities is also issued to all quasi-banks. Strict compliance to these guidelines are encouraged through quarterly, or more frequent, audits conducted by BSP auditors on a continuing basis throughout the year. For purposes of this report, it is relevant to discuss a few points regarding this regulation and the implication for the development of PFI loan portfolios in the water sector.

69. **Interest Rates.** It is, of course, widely known that interest rate levels are directly influenced by monetary policy and that these rates will shift and change from time to time based on prevailing conditions. The common tool used by the BSP in influencing interest rate levels is the control it exercises on the discount rate, i.e., the rate at which banks are allowed to borrow from the Central Bank. Variations in this rate are immediately transferred by markets to other short-term instruments such as the overnight rate, Treasury Bill and other loan instruments. Central Bank reliance on the discount rate for the purpose of equilibrating prevailing market and economic conditions, discourages "fixing" interest rates on long-term loans. BSP moves in this regard can easily impact the cost of funds for banks.

70. It would be reasonable to assume that over the course of a 5-7 year period, the discount rate, particularly, and/or reserve requirement will be amended from time to time based on prevailing market and economic conditions. Changes in these variables clearly represent risks for both lender and borrower. Hence, the bank is best protected by a preference for variable rate lending based on its ability to re-set interest rates periodically in a term loan to better align its internal revenue and cost structure. The borrower would prefer to fix rates so as to eliminate some of the uncertainty associated with interest rate fluctuations. The market for derivative products that would eliminate interest rate risk for borrower and lender is underdeveloped in the Philippines and does not represent, as yet, a solution to the issue.

71. **Collateral Issues.** For commercial banks that operate in the Philippines, a key principle of lending is quite straightforward, "the more secured or collateralized a loan is, the less it will count in the "Risk Asset Profile" of its loan portfolio. There are risk asset benchmarks set by BSP, which banks are encouraged to abide by. When a bank imposes collateral requirements on borrowers, it is because it is

required to comply with directives regarding risk management principles imposed on it. Even if the regulators agree to assign certain 'collateral value' to underground distribution pipes, they probably wouldn't agree to a depreciation period beyond 2-years for this asset. Hence the need to continue offering sufficient collateral cover for a 5-7 year term loan would require the borrower to replace the collateral every 2-years, in order to maintain its loan. This issue becomes clearly relevant if the bank sector is to meet SWU requirements for expansion loans with extended maturities, grace periods, and reasonable interest rates. While it may be acknowledged that SWUs carry values as "ongoing concerns", these values are contingent and, evidently, not factored into the Risk Asset Profile as risk reduction values.

72. In addition to the impact of unsecured or under-secured loans on the Risk Asset Profiles, there is also a direct impact on the level of loan loss reserves that a bank is required to set aside for such loans. The less security attached to a loan, the higher the loan loss reserve required. Higher reserves impact on "loan-able funds" and of course, the reported earnings (under generally accepted accounting standards) of a portfolio. To address the profitability angle, banks normally tag under-secured loans with higher interest rates, a compensatory move that may be understandable from the lenders' perspective, but contrary to the basic needs for water sector loans.

73. Risk Management. The banking sector is encouraged to adopt risk-based lending into its operations, especially with the advent of Basle I and II. The full adoption of the standards therein, however, has encountered some hitches in implementation. The extent of adaptability of any risk rating mechanism/system is measured by the availability, dependability, consistency and general quality of the required inputs to that system. It is also dependent on the applicability to the sector of the major assumptions which underlie the system. While any system can be made to "work", the quality and dependability of the output will always be a function of the quality and reliability of the inputs.

74. The example of LGU Guaranty Corporation (LGUGC) is pertinent to this discussion. This institution is jointly owned by the private sector (through the Bankers Association of the Philippines), Asian Development Bank and the government (thru the Development Bank of the Philippines (DBP). It was created to guarantee extensions of credit to LGUs, in this way facilitating the flow of private financial resources into the LGU universe. Assisted by USAID funding, LGUGC has developed a "rating system" for a significant number of LGUs. The system is based, of course, on data and information painstakingly gathered for this purpose. The data is updated on a continuing basis. The difficulty associated with implementing the system is best illustrated by the inability of the LGUGC to extend its rating system beyond the largest and best known LGUs, despite the fact that the effort has been going on for many years.

75. The Philippines is still characterized by a chronic lack of reliable and consistent input data that would enable the financial sector to make a smoother transition into a cash flow lending paradigm using reliable risk rating methods. More than anything else, this would enable a departure from the more traditional collateral-based lending practices of the past. This type of shift cannot be the result of a one-way effort by the financial sector. It is equally dependent on major changes in the way business and industry does its accounting, preparation of financial data and reporting to external stakeholders.

VI. Can the gap between supply and demand be narrowed?

76. Much has been discussed about the problems/constraints facing the supply side in developing significant exposure in the water sector. If the gap is to be narrowed, the problems/constraints from the lender's perspective must be addressed, directly or indirectly. These include, (i) Lack of knowledge regarding SWU industry and the inability to evaluate credit risk; (ii) Issues related to the legal organization of cooperatives and associations and the potential inability of lenders to enforce remedies; (iii) Central Bank regulatory provisions, the implementation of which make it difficult for lenders to look favorably at the type of collateral that SWU can offer; and the (iv) Bankers' strong preference for variable interest rate loans as a way of controlling loan margin.

77. The first three issues above are directly related to the issue of bankability while the fourth is marginally so. Each will require solution if the SWU environment is to provide the commercial banks with a reasonable opportunity to make a fair profit within reasonable and acceptable risk levels.

78. Evaluation of bank-ability in the case of SWU involves a primary focus on the credit risk and the recourse options open to the lender for various possible problem scenarios. Recourse, however, is highly dependent on the extent and ease within which it can be implemented. In this regard, the institutional make-up of the potential borrower (cooperatives, associations and LGU-owned) is a significant determinant for a very large share of the SWU universe in the Philippines, as mentioned in earlier sections of this report.

79. Below, we set forth a number of government and non-government interventions that have been used in the past to stimulate lending to a particular sector. We divide these into two categories: interventions (a) related to collateral; and (b) others, designed to improve the attractiveness as well as the availability of private finance.

80. The issue of collateral and enforcement is vital as without it, no transaction will take place. Hence it is given a preferential place in the analysis below. Leaving aside the mortgage instrument (given that a mortgage over physical network does not appear to be optimally acceptable collateral), there are four other types of collateral which could be employed and may gain acceptability, as set forth below.

81. All of these forms of collateral require from the lender an ability to evaluate credit on a cash flow basis, which in turn require more knowledge about the sector and its regulation, better comprehension of the differences in legal standing of associations and cooperatives and more explicit guidance from the BSP regarding the standing of potential collateral that can be pledged by SWU. There are other kinds of interventions which can be used, more specifically for the purpose of improving the supply of funds that are available to SWU.

Table 4. Interventions Related to Collateral

Interventions Related to Collateral	How does it work?	Likely consequence
Internal Revenue Allotment. For LGU-owned utilities, the minimum collateral requirements will always include the Internal Revenue Allotment (IRA) that is due to the LGU. It is difficult to imagine that lenders, particularly private lenders, would not require this	Mechanically, LGU would have to agree to assign the lending PFI a 'first call' on the proceeds of future IRAs, as security, in return for the term loan. If, as reported, there are difficulties in perfecting the assignment, the use of the IRA may not, by itself, be always successful	If the instrument is properly perfected, it should tend to draw out financing for LGU-owned SWUs. *However*, it is likely to be used only for LGU-operated water bodies.
"Step-in rights" for PFI as an alternative to IRA	Instead of offering a mortgage over the entire physical structure of a utility, PFI could be provided with "Step-in Rights," i.e., the contractual right to take over the operation of a utility in the event of a loan default. Under this arrangement, which is quite common in public private partnerships (PPP), the bank would have the unilateral right to appoint its own operator to run the affairs of the water utility until the term loan is paid off.	It is unclear whether this would draw out funding from PFI, as the status of this type of collateral, in the current regulatory regime, needs definition as to its "quality." That said, no one wants to depend on this method of recovering loans. Banks rely on "step-in rights" only as a last resort. Nevertheless, this common method of collateralization avoids the expense (e.g., stamp taxes) associated with perfecting a mortgage over physical assets. Although it may resolve credit risk to some extent, it does not do so entirely. Also, from the lender's perspective, this does nothing for relative attractiveness of transaction size, liquidity risk and leaves pricing issues untouched. See below for other initiatives associated with the availability and attractiveness of PFI term credit

Interventions Related to Collateral	How does it work?	Likely consequence
Lock box arrangement	PFI agrees to make loan secured by a lock box arrangement. In this case, a new account is opened, which is controlled by the bank. Utility customers are advised to make their payments direct to this account. The PFI is allowed to debit the account monthly to service its interest and principal. The balance of the liquidity is released to the utility's usual account.	Arguably, resolves credit risk to a significant, but not complete, extent. This type of security is used in many parts of the world. Obviously the PFI would have to evaluate whether the projected cash flow of the SWU is sufficient to cover all expenses and service debt, otherwise the lock box arrangement would not solve the credit quality problem.
Escrow Account backed by LGU undertaking and, ultimately, by a Bank partial risk guarantee (PRG) instrument.	Utility sets up an escrow account, say 3-6 months of debt service as a reserve. Any time the cash flow of the SWU is insufficient to pay an installment, the debt service reserve is used. In such case, LGU promises to infuse liquidity needed to maintain the escrow account at the contracted level. The LGU undertaking could be further strengthened by a Bank PRG instrument.	Does not solve credit risk unless LGU undertaking is backed by a PRG. See further below for initiatives related to credit extensions. However, we note there are limitations to the reliance on PRGs. The instrument is difficult to apply to small transactions. Also, the extension of such a guarantee by the World Bank would require a counter-guarantee from GOP.

82. SWU borrowers, on the other hand, are likely to focus on pricing as it is often the variable that creates the most angst. Pricing not only refers to absolute cost of credit (i.e., the interest rate), but whether the latter is fixed, or floating. That said, there are a number of attributes that are important in a term loan, e.g., roll up of interest rates during construction; fixed interest rates; a reasonable grace period; and extended repayment terms are probably the most sought after.

83. The examples below of potential interventions examine the effects of each in terms of its impact on availability of credit and/or its attractiveness to borrowers. The objective is to determine whether any of these interventions is likely to result in improved availability and attractiveness of PFI term finance.

Table 5. Examples of Potential Interventions

Credit rationing, with a percentage of aggregate loan portfolio of each bank to be extended toward small water utilities, or recognizing loans to SWU as compliance to Agri-Agra Law	In many jurisdictions, credit rationing has been tried but appears not to have worked very well. This is a powerful tool, potentially, but it goes against prevailing free market philosophy. Also, from the lender's perspective, it does not resolve transaction size, pricing, liquidity or credit risks. From the borrower's perspective, loan tenor, transaction structure and pricing remain potential issues.
Lifting of reserve requirements set aside at Central bank for deposits (equivalent to the volume of loans made to small water utilities)	From the lender's perspective, this leads to improved profitability, perhaps. However, as in the previous case, it does not address transaction size, pricing, liquidity or credit risk issues. The borrower is not assured of tenor, structure or pricing.
Setting up a *re-discount window* at Central Bank, where PFI extensions of credit to SWU can be discounted at a fixed interest rate	Could be workable, if structured similar to the way that the OECD guidelines govern the extension of PFI loans to host country exporters. Guidelines developed by the authorities in the latter case have resulted in fixed-rate loans, lower interest rates, no liquidity gap issues. Bank still has to concern itself with transaction size and credit risk. From the borrower's perspective, the loan terms could be quite attractive with fixed interest rates and loan structure set by 'policy,' rather than 'prevailing market conditions.'
Creating *tax exemptions* for income derived from lending to small water utilities	This is an incentive only, does not solve for lenders, the issues of transaction size, credit risk, and liquidity risk. The incentive, however, may result in nominally better interest. Nonetheless, this would have to be used in conjunction with some other intervention.
Pooling of several credits into one global transaction	For the lender, solves the problem of transaction size. Reduces but does not eliminate credit risk. Leaves liquidity and pricing risks untouched. This has been used widely in the United States for water projects. The pool is then syndicated either to a number of banks or securitized in the bond market. From the borrowers' perspective, this initiative needs to be combined with others in order to ensure the attractiveness of the loan. It takes a great deal of transaction expertise and a group of collaborative borrower to pull one of these transactions off. However, it can be done!
Increased reliance on public private partnerships (PPP)	Has possibility for decent sized utilities. However, SWU with little or no economies of scale might not be particularly appealing to many entrepreneurs.

85. Of the above interventions, the rediscount window appears to be the most workable. Although it does not solve all of the technical issues we have discussed that arise between lender and borrower, it does address a good number. Moreover, a rediscount window could probably be combined with other initiatives to solve some of the remaining problems.

86. However, none of the measures in our table address the core problem facing the Philippines water sector – that of incoherent regulation. On paper, infrastructure projects are regarded by banks in industrialized countries as quality credits. In the US and Europe, one seldom hears of a water or power project declaring bankruptcy or defaulting on a loan. This is because economic regulation is clear and its implementation is consistent. Confidence exists that the regulator will balance the water utility's interests along with those of its consumers in an equitable way. Hence cash flow is reasonably predictable and ability to enforce is not an issue. It is quite likely that most infrastructure credit in industrialized countries is done on a clean basis or, at best, secured by mortgages over physical assets.

87. If regulation were more coherent in the Philippines, SWUs would have a much better chance of getting attention from PFIs. With good and predictable regulation in place, BSP might be inclined to make allowances in the weight that such loans have on capital adequacy, with or without collateral. Any initiatives on BSP side on this matter, however, will need to depend on improvements in water sector regulation.

88. In theory, and with good regulation, a water utility should never go bankrupt or fail to make a payment on a loan – unless, of course, its forward planning was badly done. For this to happen, however, several institutions will have failed to do their job: the SWU itself (as well as its owner), with their misplaced confidence in ability to execute; the regulator, who reviewed the tariff determination request along with the expansion plan; and the banker, who evaluated and approved the loan.

VII. More ambitious examples of government interventions and outcomes

89. With the objective of improving the availability of term finance for small water utilities, major interventions that GOP could consider are promoting new institutions, or a window at an existing institution for, respectively:

a. A new "guarantee fund" facility, preferably organized as a window in an existing institution such as LGUGC that is strictly dedicated to the SWU sector; and/or

b. A specially designed government-owned debt fund that would leverage its capital by co-financing the requirements of SWU side-by-side with private lenders. These two interventions overlap to some extent in their functions. Hence, it is better to view these as 'either/or' choices. It is also necessary to think of them as "transition" vehicles. They would exist for a defined period of time until program objectives are met, a point that is discussed further below.

90. A guarantee window would give lenders an adequate "remedy" in case of a loan default. LGU-GC was created because the institutional profile of an LGU represented unacceptable risk to the PFIs. While LGUs possess Internal Revenue Allotments (IRAs), which in theory are acceptable forms of collateral, the documentation to legally perfect the assignment is tricky and, therefore, not bullet-proof.

91. Among the lessons learned in the LGUGC operation is that guaranties to support loans in amounts less than P20.0 million have not proved feasible, given the small amounts that can be earned off of guaranty fees relative to the high inherent administration and monitoring costs involved in managing such risk. The same would be true for a similar vehicle created to support SWU.

92. There are other considerations with guarantee funds which need to be highlighted:

a. It is uncertain whether a guarantee instrument can effectively extend the final maturity of a PFI term loan and/or persuade the latter to fix the interest rate, even if the instrument fully voids the credit risk. The constraint on very long credit extensions, as noted above, is institutional and regulatory in nature, not easily resolved through the type of intervention discussed earlier; and

b. A guarantee facility, particularly a 'partial guarantee instrument,' may not draw out significant risk capital from banks. The unguaranteed portion of a loan, for example, will still be subject to the problems and issues identified earlier. Moreover, the mere existence of a guarantee instrument often leads to the wrong focus in a term finance negotiation. Instead of addressing the merits and demerits of a potential borrower's financial projections and proposed use of capital by the borrower, the negotiation might be re-focused by the lender into a different objective – that of negotiating the minimum level of risk capital needed to put the guarantee in play. In the case of SWU borrowers, guarantees will not accelerate the socially desirable objective of getting bankers to understand the water service business.

93. The alternative to the guarantee facility is an infrastructure (debt) fund. Infrastructure debt funds are a relatively new phenomenon in developing countries, first appearing in the 1990s. A typical infrastructure debt fund is usually owned by government and specializes in extending very long-term credit, co-financed with commercial banks. One outcome of very long-term finance is a reduced level of periodic debt service, a factor which reduces pressure on the tariff needed to operate and maintain the water utility while, at the same time, servicing its loan obligations.

94. The early debt funds, for example, were assisted by the World Bank's International Development Association (IDA) arm, the latter providing loans to member countries on attractive terms with the proceeds employed to capitalize the funds. Depending upon the country, the fund would co-finance with private banks the term finance requirements of selected infrastructure facilities. It would do so on a *subordinated basis* in effect becoming an important catalyst for promoting syndications and recruiting private debt. The public-private debt package was structured in a way that would permit the senior PFIs to lend and exit on normal 5-7 year terms. During this initial period, the fund would be subordinated to the senior lenders, i.e., it would receive interest on its loan but no principal repayments. Once the senior lenders were paid out, amortization of the fund's debt would begin and continue to final maturity, up to 23-years. The approach to loan syndication had the effect of creating a more tolerable debt service profile, less upward pressure on the tariffs and, therefore, a more attractive borrowing. For this reason, some of these new institutions became very effective catalysts for developing the local credit markets and encouraging the interest in lending to infrastructure facilities. One of the funds held training seminars on issues related to project finance for the banks on a periodic basis. There was significant interest in these seminars, in turn creating good working relationships between the fund and the banks.

95. As discussed in the paper, several advantages are associated with the creation of a debt fund designed to assist in co-financing infrastructure, namely:

a. The repayment debt service profile, as mentioned earlier, is far more tolerable than one in which 100% of debt is recovered under prevailing market terms. A government-owned debt fund, extending debt on a basis that is subordinated to senior lenders, would co-finance up to 40% of the loan on a basis that is subordinated to senior lenders over a period of up to, say, 10-20-years. The remaining 60% of the loans would be provided by commercial lenders on at prevailing market practices and terms (from 5-7 years);

b. The reduced upward push on the tariff path could stimulate the public's use of the facility and lead to a richer and more reliable revenue stream than otherwise, making an investment in the facility even more attractive to potential investors and lenders alike;

c. Subordinated debt acts in the same way as a structured credit enhancement (i.e., the subordination enhances the credit from the perspective of the lender) making it easier to recruit senior lenders and/or encouraging them to lend on normal terms;

d. With time and experience, subordinated loans may be sold off in the local market to institutional investors through securitizations – an instrument now widely used in many developed countries to enhance the liquidity of the banking system. This enables the infrastructure fund to replenish its liquidity from time to time without seeking new infusions.

96. The concept of a fund makes sense when there is loan demand a palpable project pipeline and lenders willing to negotiate participation. In this case, a market mover can be optimally effective, promoting SWU and assisting with project preparation while - at the same time - taking on the role of an investment banker, aligning supply and demand for funding.

97. However, there would still be something missing. A fund is most likely to be effective after the water service sector regulation is strengthened. The latter would seem to be the *one key cornerstone* around which every other hope for improvement rests.

VIII. Conclusions

98. Broadly, the objective of this paper has been to examine ways and means of attracting more private bank debt into the SWU subsector.

99. The discussion was initiated with a broad survey of the water sector in the Philippines. The different types of water utilities were identified with special emphasis on SWUs. Significant levels of latent loan demand may exist in the water sector, and particularly within SWUs, quite simply because they are located outside the major rural areas. It is a reasonable assumption to conclude that most Philippine residents that are <u>not</u> served by a piped water organization reside in these areas, as well. The SWU is where piped water supply, at the margin, meets emerging demand.

100. LGU-operated SWUs, in particular, manifest the more significant funding requirements given their physical presence as they operate in a part of the sector which is heavily politicized and unregulated. Moreover, LGU-operated water bodies require more than just credit, including capacity building and

institutional strengthening which they do not appear to have access to. Subject to political intervention, they appear to lack capacity to implement a balanced program of performance improvements and tariffs that permit full cost recovery.

101. The water utilities, like other economic enterprises operated by the LGUs, are not commercially operated and their financial operations are subsumed within the financial structure of the entire LGU. If they are to attract potential private financing institutions, it is urgently required that they ring-fence their financial operations, implement appropriate financial systems and start operating in a "commercial manner".

102. Our paper has also explored the attitudes of the PFIs in lending to other SWU. Unsurprisingly, most express little knowledge of how the sector works, which certainly constitutes an impediment. But the PFIs also express unease with regulation, the uncertain value to place on the physical plant as collateral, legal issues involved with perfecting security, and the organizational structure employed by LGUs, cooperatives and associations. The SWU borrowers, on the other hand would like to access more bank credit but do not presently have the capacity to produce commercial quality feasibility studies, financing plan, or loan proposals. This is particularly applicable to non water districts, like the LGU-operated utilities, cooperatives, RWSA, BWSAs, HOA and private utilities e.g., those that lack an organizational form that has perpetual life. The water districts have the distinct advantage of having the "one stop shop" assistance from LWUA where there is focused assistance from project preparation to loan packaging.

103. If one was to rank the issues that represent impediments to accessing PFI loans in the rest of the water sector, however, it would appear that issues related to regulation are at the very top in importance followed by others that are generic to SWU and PFI in that order, as set forth below.

a. Regulatory issues

- Many institutions are involved in the regulation of the water sector, but there does not seem to be any coherence to the regulation. Many different bodies are involved in regulation, all using different approaches. In particular, there is a serious gap in setting tariffs based in part on the use of operating performance standards;

- Tariff setting should be standardized as much as possible and performance standards for the SWU formalized – after allowing the SWU some transition period before the new approach is rigorously applied.

- There remain a large part of the sector which is unregulated,'' in particular the LGU-operated water utilities which are regulated by their owners. Within the LGU - where the policy making, regulation, and service provisions are within one organization - there is limited, or no, check and balance at all. The responsible body that regulates the water utility is the same one that provides the service and develops and implements policies affecting water supply provision in the LGU. Where such condition exists, regulation cannot be trusted to be consistent and balanced.

- With regard to bank regulation, BSP's collateral requirements need to be better understood, and particularly, the Guidance Notes related to the determination of a portfolio's risk asset profile. Also, value attached to non-traditional collateral such as 'step in rights,' 'lock box arrangements' and 'escrow accounts' need to be included in the Notes, if they are not already;

b. SWU

- Insufficient capacity in water utility management. SWUs, in particular have little experience in developing commercial quality long-term development plans, pre-feasibility studies or financing proposals. This is more pronounced at the level of SWUs which are not classified as water districts as they do not have the constant institutional development assistance which water districts get from LWUA. These utilities are also less regulated or not at all as in the case of LGU-operated utilities.

- As financial viability is directly linked with the ability to implement adequate tariffs, the LGU-operated utilities more often have the problem of adjusting tariffs to appropriate levels because of their political character. The water districts on the other hand, while they are also government organizations, are less political than LGU-operated utilities and probably have more impartial tariff regulation.

- It is strongly suggested that government consider reorganizing "LGU-operated water bodies" into "water districts," in order to enable them to access LWUA's capacity building programs and loans. In addition, government could consider providing incentives to neighboring LGUs to consolidate their respective small water bodies into a much larger organism.

c. Issues with PFIs

- Lack of knowledge regarding SWU industry and the inability of loan officers to properly dimension credit risk for several reasons: inconsistent and fragmented regulation of SWU; unfamiliarity with the technical aspects related to the water business; fear of potential politicization of tariff setting, etc.;

- Gaps in the legal framework that prevent PFI officers from entertaining requests for loans from cooperatives and associations, either because of the fear that management continuity is not assured or the suspicion that loan remedies, should the need arise, will not be enforceable. The inability, or difficulty, involved in perfecting the assignment of an IRA appears to be the type of problem that falls into this category as well;

- Capital adequacy provisions which make it difficult for lenders to look favorably at the type of collateral that SWUs can offer without affecting their Risk Profile and level of capital adequacy;

- Bankers' strong preference for variable interest rate loans as a way of controlling margins – a factor which in some circumstances may dissuade SWU from approaching banks.

104. Our report has also explored numerous interventions that might draw out more loans from the PFI in support of SWU, including the creation of a guarantee fund and an Infrastructure (debt) fund. While the latter appears to be the more suitable instrument for introducing SWU into the credit markets, it was noted that on its own, without a better regulatory framework, it is unlikely to be successful.

105. The general objective of increasing PFI lending to SWU has to start with sound regulation as a foundation. Once regulation is in place, with clear and understandable rules and performance benchmarks, it will be easier for PFI officials to evaluate the creditworthiness of an SWU. Utilities, as a matter of principle, are often highly sought after by PFIs in the West because they carry large and predictable balances, borrow once every few years, and do not absorb large administrative overhead from the PFI. There is no reason why this cannot be the case in the Philippines.

Annex 1. Key Constraints to Small Water Utility Access to Finance

Major Issues/Constraints Expressed by the FIs	Potential Mitigation from the Supply Side	Potential Mitigation from the Demand Side
Unfamiliarity with the water utility business, and associated legal/institutional/regulatory frameworks	Increased familiarity of the water utility business— specifically, a meeting or an initial assembly of like-minded PFIs and water utilities, to be followed by institution-specific capacity building, if appropriate Establish special lending units to serve small- and medium business enterprises (including small water utilities)	Loan applications to GFIs only
Continuity in management	Increased familiarity of the water utility business *(ref. above)* Well-defined management takeover covenants, assuming institution-specific relationships with qualified operators have been established and are at the ready	Admission of a board director nominated by the financing institution
Collateral coverage	Negative-covenant/waterfall account Guarantee services—similar to the LGUGC Well-defined management takeover covenants *(ref. above)*	Real estate mortgage Internal revenue allotment, in the case of an LGU Collateral business
Significant loan "closing costs" relative to the loan amount	Level of effort/cost MAY BE mitigated with increased familiarity with the water utility business (improved focus) and comfort with the applicable collateral coverage option	Clustering of loans from several LGUs, cooperatives, or RWSAs
Non-corporate identity of the borrower	Increased familiarity of the water utility business, researching well legal remedies that are available to FIs (*e.g.*, under the Cooperative Law)	Formation (by cooperatives) into a water district
Matching preferential rates (favored by the water utilities) with the desired yields (favored by the FIs)	Availability of rediscounting	

Annex 2. Small Utility Access to Market Credit PowerPoint Presentation

Small Utility Access to Market Credit

Lessons from the Small Utilities Improvement and Financing (SWIF) Project

Jema Sy, Institutional Development Specialist
WSP, World Bank
11 December 2008

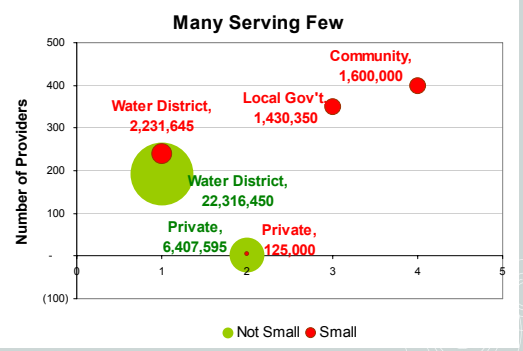
Small utilities is where piped water at the margin, meets emerging demand

SWIF aims to improve the viability of small utilities and support them to increasingly access market-based financing in line with Government's Water Sector Financing Strategy

- **Majority of piped providers - small**
- **Outside major cities - clients generally lower income**
- **Growth potential is large**
- **Dept of Finance request**

SWIF Components

1. **Performance Improvement & Investment Planning**
2. **Customer Satisfaction & Willingness-to-Pay**
3. **Improving Access to Private Finance**



Small utilities is where piped water at the margin, meets emerging demand

Are small water utilities ready and able to access private credit financing?

Not quite ready, not quite able? Maybe, it's not about 'small'

This presentation touches on:

- Potential financing requirements of SWUs
  - Global estimates
  - Specific case studies
- Match between bank lending policies and SWU needs
- Other key issues impacting availability of SWU Credit
  - Regulatory framework of the water sector
  - Organizational issues of SWUs
- Bridging finance & credit gaps
  - Rediscounting
  - Debt Fund
  - Collateral

What we (don't) know about the universe of small utilities

- Water Districts
- Local Government Unit (LGU) owned and managed
- Private water companies
- Community owned & managed
  - Home Owners' Associations
  - Cooperatives
  - Rural and Bgy Water & Sanitation Asso.

Type	*Small (%)*	*Total*
Water Districts*	**240 (40%)**	**594†**
Local gov't owned & managed	***350⁺ (52%)***	**660^**
Private water companies	**5 (55%)**	**9**
Community & Home Owners *	**109# (27%)**	**400**

*Based on records of LWUA and NWRB; † Includes non-operational water districts; ^Based on estimates by project team; ⁺ With records in DILG; #With records in NWRB

How estimates of local government utilities were derived

	No.	%
Municipalities	1,495	
Cities	136	
Total	**1,631**	**100%**
Less		
Water districts (incldg non-operational)	594	43%
Cities & municipalities additionally covered by metrowide & integrated WDs	108	
Cities & municipalities in Metro Manila	17	2%
Other privately provided cities and municipalities	7	
Other Service Providers (estimated at 15%)	245	15%
Balance: Assumed Covered by LGUs	**660**	**40%**
Of assumed LGU-covered towns, DILG records for	*350*	*52%*

Philippines MDG-7 - 86% of population with improved water

2004
81 million population
80% with improved water coverage

45% by piped water or,

36 million people with piped water

2015
103 million population
86.5% MDGs target for improved water

maintain 45% by piped water or,

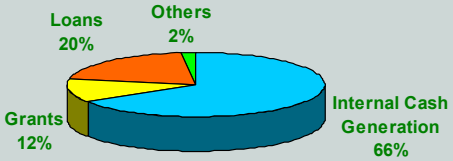
40 million people to have piped water

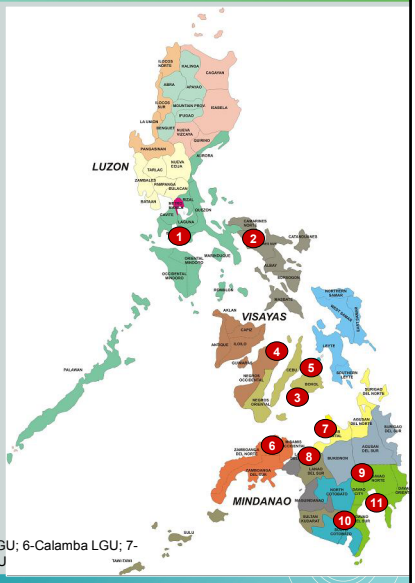
Estimation
- Additional 4 million people with piped connection
- At USD 200/capita
- Total for piped water investment is approximately **USD 800 million**
- Assume 50% served by small utilities, **USD 400 million** in next 7 years

SWIF utilities will invest USD 4 million, mostly own funds, 20% loans

Investment of 11 Utilities (2009-2013)
- USD 4 million or USD 70,000/utility/year
- **Additional 70,000 pax with piped connection**
- Unit cost of USD 50/person
- Doubling to tripling book value of small utility assets

Financing the 5-Year Investment Plans of SWIF Utilities





1- Darasa RWSA; 2-Buhi Coop; 3- Antequera LGU; 4- San Carlos LGU; 5- Tagbilaran LGU; 6-Calamba LGU; 7-Medina LGU; 8- Initao LGU; 9- Maragusan Coop; 10- Padada Coop; 11- Sto. Tomas LGU

Customers are willing to pay, but pressure on tariff need to be managed

- Compared to HHs with piped water, unconnected HHs:
  - Spent 1% more of monthly income
  - Paid 70% more for water each month
- Customers satisfied with service by & management of small utilities
- Service improvements would be met by increased payments from customers:
  - Php 122/month for improved pressure
  - Php 66/month for good quality; another Php 106/month for superior quality
- WTP values will cover the proposed new investments' impact on tariffs , BUT:
  - Bill will rise to 2% of monthly HH income from <1%
  - Where service is already superior and tariffs high, ability of a small base of customers to finance expansion through tariffs becomes limited

Customers are willing to pay, but pressure on tariff need to be managed

Interventions on structuring finance is critical especially for private credit – combined use of grants and instruments; diversify to other types of finance

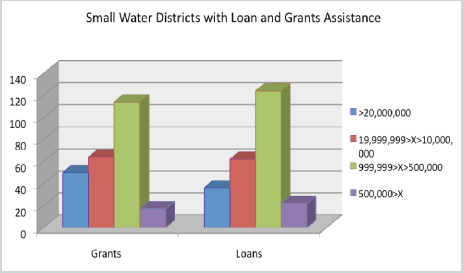
Want-got gap of small utility, driven by want-got gap of private financiers

Utility WANT	GAP	GOT	GAP	Bank WANT
Longer terms	18 months to 5 years from LBP, DBP and rural banks *10-20 years from NHA, LWUA*			Matched to source of funds; liquidity
Fixed interest rates	Fixed for short durations *Fixed for long from NHA/LWUA*			Floating - matched to variable discount rate, reserve requirement & market
Smaller loan amounts, or multiple draw-downs	Working K at 23% p.a. Php 1-3 M single loans No multiple draw downs			Adequate spreads and 'economies of account size' Matched to administrative cost Pref. > Php 20 M
More favorable pricing – interest rate	11-14%, 23% p.a.			Adequate spreads and 'economies of account size' Matched to variable regulatory requirements & market
No or realistic collateral requirements	Special Savings Deposit; Mortgage on Buildings and Equipment; IRA; Personal pledges of managers			Low credit risk
Assistance for investment planning and project dev't	Occasional support from gov't and donors			Investment proposals that breed confidence

Presently, only water districts enjoy all 'utility want' financing features

But opposing aims of nurturing and lending to the un-creditworthy, finds LWUA in a financial bind

- LWUA revising their market positioning to cater to semi- and pre-credit worthy utilities (water districts)
  - With grant support
  - Soft loans



- The lesson is that in the 80s it should have been recognized that LWUA was intended as a policy-based financing window
  - is not market financing
  - will need subsidy
  - needs a sunset clause

Summary of financing gaps related to SWU access to market credit

1. Lack of familiarity of FIs with the water sector
2. Mismatch between SWU financing needs and Fis desires:
   a. Fixed versus variable interest
   b. Long-tenors versus liquidity
   c. Size
   d. Credit risk

Bridging the financing want-got gaps

1	Credit rationing, with a percentage of aggregate loan portfolio of each bank to be extended toward small water utilities (Agri-Agra)	Tried in many jurisdictions, appears not to have worked very well. It does not resolve transaction size, pricing, liquidity or credit risks.	From borrower's perspective, loan tenor, transaction structure and pricing remain potential issues
2	Lifting of reserve requirements set aside at Central bank for deposits	From the lender's perspective, may lead to improved profitability. However, does not address transaction size, pricing, liquidity or credit risk issues.	Borrower not assured of tenor, structure or pricing

Bridging the financing want-got gaps

3	Pooling of several credits into one global transaction	For lender, solves problem of transaction size. Reduces but does not eliminate credit risk. Leaves liquidity and pricing risks.	For the borrowers, this initiative needs to be combined with others to ensure attractiveness. May not address size and flexibility issues. Takes a great deal of transaction expertise and collaboration, but doable

Bridging the financing want-got gaps

4	Increased reliance on public private partnerships (PPP)	Has possibility for decent sized utilities.	SWUs with little or no economies might not be particularly appealing for PPP

Bridging the financing want-got gaps

5	Setting up a re-discount window at Central Bank, PFI extensions of credit to SWU can be discounted at a fixed interest rate	Results in lower interest rates, no liquidity issue. Bank still concerns itself with transaction size and credit risk.	From borrow's perspective, loan terms attractive, fixed interest rates
6	Creating tax exemptions for income derived from lending to small water utilities	This is an incentive only. Does not solve, issues of transaction size, credit risk, and liquidity risk and would have to be used in conjunction with some other intervention.	

Rediscounting Option with the BSP or other entity

Features
- A special window for SWUs at the BSP
- BSP will purchase loans from FIs on a "with recourse basis" at predetermined fixed interest rate
- Discount rate is the fixed interest rate paid by the FI to the BSP

Issue of Mechanics
- Fixing interest rate by policy
- Determining the discount term and allowable margin for the FI
- Should be a special program; due to/due from accounts treatment should not be affected

Advantages
- Will address liquidity issues related to maturities of an FIs assets and liabilities
- It will fix the "yield or interest rate (pricing) risks"
- Credit risk remains with the FI

Limitations
- Leveraging of private funds is limited

Debt Fund

Features

- Government-owned debt fund co-finances side-by-side with private lenders
- Government finance will be lent on subordinated basis
- Transitional vehicle – exist for a defined period of time

Issue of Mechanics

- Setting up the debt fund
- Locating the debt fund with a manager

Advantages

- Debt service profile is more tolerable for utilities
- Will address liquidity issues related to maturities of an FIs assets and liabilities
- Acts as a structure credit enhancement
- Debt fund manager can assist project development and promotion

Alternatives to collateral

1	**Step-in Rights**	**Contractual right to take over the operation of a utility in the event of a loan default; unilateral right to appoint an operator**	**Unclear if this is considered 'quality' under regulation; PFIs likely not want to rely on this Partial credit risk**
2	**Lock box**	**New account is controlled by the bank where customers are advised to make their payments direct to this account**	**Resolves credit risk to a significant, but not complete, extent.**

Alternatives to collateral

3	Escrow account backed by LGU undertaking and, ultimately, by a Bank partial risk guarantee instrument	Escrow account (e.g. 3-6 months of debt) as a reserve. If cash flow insufficient to pay an installment, reserve is used. LGU promises to infuse liquidity needed to maintain the escrow account at level. LGU undertaking could be further strengthened by a Bank PRG instrument.	Does not solve credit risk unless LGU undertaking is backed by a PRG. Note limitations to the reliance on PRGs: difficult to apply to small transactions

Alternative collaterals need regulatory support

- All are cash flow-based evaluations
- Require more knowledge about the sector
  - Industry information
  - Provider accounts
  - Regulatory regime
  - Legal regime of different providers (e.g. associations, cooperatives and local governments)
- Explicit guidance from BSP regarding the standing of potential collateral that can be pledged by SWU

Don't forget important issues that will not be addressed by financing

Regulatory Framework		SWUs Organizational Issues
Too many institutions and lack of clarity in roles		Insufficient capacity to prepare corporate plans & project proposals
A large part of the sector is unregulated (e.g., LGUs) or 'other' regulated (e.g., through congressional franchise or contract)		
Tariff setting and performance not standardized		Inability of LGU SWUs to raise tariffs