

**OSCE Conference:**

**“Key challenges to ensure environmental security and sustainable development in the OSCE area: Water Management”**

**Session 4**

**- Notes on financing reform and the role of good governance**

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*(the views expressed here do not necessarily reflect the official position of the European Investment Bank)*

*Investment needs of the water sector and delegation*

At the top of the present international agenda for the water sector are the Millennium Development Goals and Integrated Water Resources Management. The essence of the MDGs is the need to scale up the pace of investment as well as extending water services to low income groups and marginal areas. The cumulated experience of evolving water sectors in developed and developing countries is there to be used.

The scale of the investment challenge on the water sector will imply a greater degree of delegation of project preparation and management from the international community to governments as well as regional and local authorities. Ultimately, the ability to increase investment to significant levels relies on transparent and capable formal and informal structures within the countries. The central question of delegation is one of finding the appropriate level or promoting suitable structures where these do not exist.

The European Union's growing experience with the Water Framework Directive is demonstrating that enabling a structured dialogue between national/regional authorities and local communities contributes significantly to cost-efficient and sustainable implementation of Integrated Water Resources Management.

Relevance to real needs and a sense of ownership among industry professionals and the public are key to successful implementation of projects. These factors are also in themselves a mitigating factor against intransparency and corruption, which thrive more easily in an environment that is primarily driven by the availability of money, rather than by real needs. While environment and public health are complementary, the latter carries a greater weight as seen through the local perspective. The development of public health, environment and financial autonomy of the water sector therefore needs to be a balanced one, which requires a phased or gradual approach where there are financial constraints.

*Financing reform*

The water sector in the developed world came to be and continues to benefit from a significant role of central and local government as well as cross-subsidy between urbanized and marginal areas or between consumer groups where there are affordability

constraints. It is doubtful if the same principles will not also appeal to transitional and developing economies, where international grants are not made available to fill the gap.

Irrespective of the availability of grants in the near future to transitional or developing countries, sustainable services ultimately rely on the political willingness to require citizens to pay the full cost for these services over tariffs and/or taxes, the impact of which can be softened significantly through long-term loans.

The availability of advantageous funding is a very effective means to drive reform if it is backed by clear and consistent national policy and addresses real needs. Loans instill a sense of financial responsibility and focus on performance. In the context of applying taxpayers' money or concessionary loans, only cost-effective solutions are justifiable. Moreover, the need to ring-fence the interests of the financiers requires transparency and a certain degree of autonomy. The search for cost-efficiency and transparency therefore spills over into sector reform by virtue of seeking an appropriate scale or project configuration.

In overly fragmented environments the (re-)agglomeration of operational units – also known as regionalisation - is a means to achieve critical mass in relation to project implementation capacity and financial and operational sustainability. There are many drivers to this process, such as investors seeking capable project promoters, the desire for economies of scale, ownership issues or a long-term vision to converge towards basin-level structures. The stick-and-carrot approach is effective, with government driving a clear policy with a conducive legal environment that provides a clear division of responsibilities and advantageous funding being made contingent on clear commitment at local level to take part in the process. The process is best supported by keeping a clear distinction between the short-term process of preparing projects and the medium-term process of institution-building, although the two can be linked by key milestones. However, there is no one-size-fits all. While money can leverage collaboration in societies where trust has broken down, forced collaboration may backfire in terms of lost ownership.

Reform and the roll-out of infrastructure are mutually reinforcing. By extension, where there is little progress on the ground, little is achieved by way of engaging a sustained commitment and reform. Experience has shown that a balance must be struck between driving development with the use of conditions tied to the disbursement of funds and not setting up too many obstacles to maintaining momentum and commitment. Relevant and phased conditionality can effectively be tied to funding where there is confidence that this will contribute to driving the process forward, rather than merely defer difficult issues where there is no real will or scope to address them. A higher degree of delegation of responsibilities goes hand in hand with policies of engagement to promote efficient and transparent structures through local stakeholders.

### *What do IFIs do?*

The primary concern of IFIs is the sustainability of projects, which extends beyond the ability for timely repayment of debt, which can be addressed through an appropriate guarantee structure or assessment of creditworthiness, or cost-recovery for operation and maintenance. It is important to recognize the limited reliability of analytical methods in environments with high socio-economic and political uncertainty, which for instance may render a purely financial view of sustainability misleading or unnecessarily restrictive.

IFIs are primarily qualified to identify and manage risk and give advice on financial management and project structuring. They apply a number of risk mitigating measures such as environmental and social safeguards as well as their supervisory role in procurement. IFIs can also act as facilitators, such as between experts or sector professionals, or as mediators of real experience. However, the role and reach of IFIs in reform and control has its limits. There is no substitute for the rule of law and active civil society as effective safeguards to provide confidence to responsible international investors.

The ability to leverage reform through money stems primarily from the attractiveness of the funding proposition in relation to alternatives. Therefore donor and IFI coordination are prerequisites for reform to take root effectively. The investment challenge sets governments on the difficult path of managing scarce financial capacity among competing sectors in a sustainable manner. IFIs have a responsibility here to coordinate and to use joint leverage where necessary. Ultimately, this means understanding the signals being sent, how these interact with expectations, and avoiding conflicting signals.

### *Private participation and capital in the water sector in perspective*

A process of trial and error over the past decades has shown that private investors have not been willing to participate at a level that can fuel a turn-around for municipal water services in regions of great investment needs. However, the commercial practices of the private sector have played a global role in motivating the water sector to become more efficient and more self-aware.

Moving towards delegation, the reduction of the role of government or commercialization does not imply private sector involvement, nor does it imply any particular form of financing. Moreover, a systematic policy of seeking more commercially priced money if this can only be done by increasing grants from another source - because of affordability constraints – will yield little mileage on the ground. Public owned limited companies operating on a commercial basis and benefiting from state support through guarantee or subsidies have been successful in many countries and a way forward before involving the private sector, for instance.

As the private sector develops to respond to the needs and culture of water services and expectations of the private sector become more realistic, there is a potential for public private synergies in the management of water services and the roll-out of infrastructure.

Private service contracts for capacity building and improved implementation and operation are a useful option, provided that the promoter is able to manage it properly and take maximum advantage of it - otherwise an expensive service is wasted. Where risks and benefits are easily quantified and critical skills are needed, the private sector is also likely to be able to make a valuable contribution to financing. However, PPP without a strong public counterpart is not viable.

#### *The rule of law in the water sector and civil society*

The primary drivers of sustained investment in the water sector are regulation and enforcement of the rule of law to safeguard public health and the environment. Without the latter, the water industry would cease to exist. This is particularly evident in post-conflict regions, where much derelict infrastructure is a result of neglect during periods of weak or fragmented governance.

Corruption is a serious drain on resources on the water sector as in other sectors that involve large capital investments or large flows of money. Ultimately, it is addressed most effectively through the interests of national and local stakeholders who are poised better to deal with it, on the basis of constructive engagement and long-term policies. More and heavier conditionality is unlikely to respond to need for a scaling up investments, unless it truly implies promotion of local institutions to take on the role of ensuring transparency and accountability.

Lack of competence as well as structural flaws in the water sector are potentially a far greater drain on resources than corruption seen in an isolated sense, even though the two can be mutually reinforcing. In certain countries, decentralization has led to fragmentation of the water sector, which has compounded lack of financial resources with the problems of unclear or unenforced responsibilities for public services and unsustainable operational units. The intransparent sale of public patrimony or rights has often accompanied such developments, stripping local communities even further of potential resources.

Civil society has a very important role to play in increasing awareness among the population of public health matters as well as the environment and to reinforce the accountability of public decision makers. This is particularly the case where governance has broken down and needs to reemerge. In this regard, the strengths of the OSCE are its local presence and perceived neutrality that clears the way to catalyzing the dialogue for reconciliation, public expression of interests and engaging civil society and local communities constructively.