



## ***Domestic Private Sector Participation Initiative***

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# **Supporting the market that serves the urban poor: Emerging responses to enhance the role of local private sector providers<sup>i</sup>**

## **Background paper**

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The international community set an ambitious development goal to be reached by 2015: to reduce by half the number of households without access to adequate water supply and sanitation services. In spite of the impressive progress reported in a handful of countries, the number of people lacking basic services has increased significantly over the past 20 years, especially in large African cities where the rate of urban growth should generate significant concern amongst those responsible for urban services. Conventional service provision by large water utilities (public or private) has been unable to respond to the rapidly growing, increasingly complex demand in irregular, illegal, low-income, core and/or peri-urban settlements. Without innovating and finding new ways of dealing with WSS service provision, the MDG challenge will not be reached in most developing cities.

Understanding who provides water and sanitation services to the poor in practice is critical to the development of sensible MDG roadmaps. While municipalities or utilities may have the mandate and responsibility for provision of water supply and sanitation (WSS) services, in many cities and towns in Africa, Asia and Latin America, these formal services are estimated to meet between 10 and 60% of the household demand for drinking water.<sup>ii</sup> An additional 5 to 20% buy water from an informal private operator who in turn purchases the water from an operator contracted by the local or national government. And the remaining households? they manage as best they can by paying informal businesses to provide them with services or by supplying themselves.

The competing interests for land and the excessively polluted groundwater resulting from urbanization and high population density now means that self provisioning in urban areas has become increasingly difficult, and the reliance on informal services is increasing. As a consequence, a new market has boomed: householders ready to pay the full cost for water and sanitation services but unable to obtain a connection from the formal municipal provider. This rapidly growing market has generated a complex and substantial response within the local private sector. In Maputo, Mozambique, 200 small distribution networks were built by private investors without contract, and now supply a quarter of the city. In Nouakchott, Mauritania, the sanitation market, now mostly comprised of privately operated informal suction trucks is the predominant sanitation service provision in the city and has grown fivefold over the last ten years.

Consequently, the local private sector in water and sanitation services now constitutes one of the most rapidly growing sectors in urban economies, illustrated through figures describing job creation, rising turnover and increase in customers.<sup>iii</sup> The success of the local private sector to date, and the opportunity for this part of the market to increase service coverage to the poor is based on evidence that local private providers (i) know how to meet the demand of a variety of customer groups; (ii) consider the poor as a potential market, rather than as a burden; (iii) are willing to invest even in irregular and illegal settlements where legal guarantees are not forthcoming; (iv) are not bound by unrealistic standards determined by outsiders with little practical understanding of the Poor's needs and capacity; and (v) are diverse in nature and able to respond to the diversity of community demand.<sup>iv</sup>

With this background, in nearly all low-income countries, the debate over the advisability of engaging with the local private sector has become academic. In practice, the urban poor buy water and sanitation services from formal and informal local private sector actors and they will continue to do so for a decade or more to come. The future of water and sanitation service delivery to the poor in low-income countries (and fragile states where state services do not exist) lies in a multi-stakeholder service delivery strategy that builds on existing potential, that provides options to consumers, and focuses not on ideal urban solutions but on practical steps that put water in the hands of the poor, in the short term. Over the last decade much has been learnt about the characteristics and behavior of small scale, informal, intermediate, independent, local private sector providers.<sup>v</sup> This short paper does not aim to reproduce this wealth of information but to focus on a few of the more problematic issues emerging and preventing scaling up. It then considers a framework for identifying the nature of reforms that will enhance the role of the local private sector in service delivery to the urban poor.

## Challenges to scaling up the local private sector role in WSS service delivery

**Service delivery in irregular settlements.** The absence of formal utility service in low-income urban areas results both in a high level of illegal connections and a niche market for the local private sector whose response to user demand and ability to manage risks will absorb the risk of expropriation or demolition. As illegal settlements will grow for many years, the challenge for the formal utility is to identify innovative procedures and devise action plans to enhance the efficiency of the local providers' service and the reduce the risk borne by the consumer and the provider – quite irrespective of the land regularization process. While progress on this front is slow, innovations in Abidjan, Casablanca, and Nairobi, where bulk water has been supplied at the periphery of slums and assists the utility to limit the losses due to illegal connections while developing new sources of revenue, and enabling local providers to provide a better service at a lower cost. Experience in these cities provides a model for other utilities to replicate. The development of comprehensive strategies and action plans that include local private sector providers is an urgent step if new operators are to be supported in the market.

**Institutional incompatibility.** Most municipalities and utilities have limited experience with local private operators, little understanding of how to work with them and why they should change the service delivery status quo. Understanding the disincentives for utilities to work with local private sector providers and developing appropriate incentives for officials to engage with them is critical to change. Action is necessary on a number of fronts:

- *Understanding user-demand in strategies for service delivery.* The services supplied by local private operators often respond to user demand but do not correlate with conventional performance standards. Moreover, integrating these services into the strategy for public service provision weakens the rationale for the high cost, high standard infrastructure preferred by utilities.
- *Reconciling informality with conventional procedures.* Most small operators are informal, impossible to contract, and difficult to monitor. Identifying mechanisms to overcome the incompatibility of informal business practice and formal procedures is essential if providers and utilities/municipalities are to work together.
- *Sharing the market.* Water utilities typically capture the market through their monopoly status and officials are concerned that formal revenues and informal payments will decline with more recognition of local providers. Evidence in a number of utilities suggests however that bulk supply contracts can result in win-win agreements with formal and informal businesses and provide an incentive for both to share the market.
- *Changing attitudes.* Utility officials do not understand local private operator's working methods, the logic of their business or the rules of the informal market, and they do not have the toolkits or skills to work with these operators. Unsurprisingly there is often a deep mistrust between technocrats and the local entrepreneurs. The perception of providers as exploitative thugs and officials as ignorant bureaucrats needs to be dismantled and mutual trust developed through concrete successes.
- *Resolving technical differences.* Local private services have been developed quickly but independently of public service assets – often in the form of separate networks, 'ad hoc' equipment, and small diameter pipe work. As a consequence, linking infrastructure may be technically difficult and financially unviable.

**The fixing of tariffs.** Tariff setting by regulators typically draws on information concerning production costs. However in the case of local private sector services this information is not available or used. Tariffs are then frequently fixed too low, and local operators ignore them and buy the enforcer's silence, perpetuating sector corruption. Or they are fixed too high, and consumers, especially poor consumers bear the burden of this ineffective price regulation process. The most effective instrument for tariff regulation in the informal sector is and will continue to be competition. The regulatory challenge is to ensure monopolies are reduced and competition is enhanced. In the sanitation market in Dar Es Salaam, the tariff for septic tank extraction was fixed over a decade ago at a higher level than the market price, but as more providers entered the market and competition increased, the prices declined considerably.

**The targeting of pro-poor financing mechanisms.** Where they exist, subsidies and incentives created to compensate for the lack of profitability when selling water to low-income user groups, are invariably channeled through formal institutions. Given that the majority of the poor are not receiving their service from these institutions, these subsidies and other soft public finance mechanisms are not benefiting poor consumers. The question of supporting the real providers of services to the poor

(informal and often illegal entrepreneurs operating at high risk) with public money is obviously problematic. Various financing mechanisms have been tested to date and a comparative analysis of their outcomes (and efficiency) is needed in order to identify and replicate the most effective financial tools. Output-based aid mechanisms (OBA) look promising, e.g. subsidies that are passed on to resellers in the form of discounts on the bulk water tariffs for supply in poor neighborhoods.

**Professional associations or cartels?** Developing a dialogue and negotiating with the sheer numbers of individual entrepreneurs involved in service delivery in low-income settlements is impossible. It is necessary to identify interlocutors who can speak on behalf of the providers and fully articulate their needs, constraints and potential. Associations of providers have been established in many countries (e.g. Aguateros in Paraguay, stand post managers in Abidjan, water tankers in Accra) and recognition of the usefulness of these trade associations is developing. Associations can play a very active role in assisting active authorities resolve blockages. Typically they can help members to define and enforce practical standards, train members in technical and contracting innovations, optimize distribution systems, and establish consensus and solidarity within an otherwise disparate group of entrepreneurs. They can also provide the potential vehicle for constructing facilities beyond the capacity of a single business (e.g dumping sites, waste water treatment plants.)

Despite these benefits it is also clear that these associations can be used to negative effect and have an adverse impact on the poor. Any organization formed around collective goals finds ways of protecting or improving member interests (e.g. to increase market share, create monopolies, obtain access rights) over the interest of their customers, and in this case the customers are poor. The borderline between a professional association and a cartel is thin. A key challenge of future work is to understand better the internal dynamics of water provider associations, to develop tools to monitor their orientation and to define precautionary measures and rules that limit the emergence of cartels likely to hamper the development of a fair, pro-poor water market.

**Shifting from small to medium.** The success of local private sector activities is due to their capacity to identify local needs, develop commercial niches, propose appropriate solutions – and due to their informality. But the constraints surrounding informality also prevent their development. In order to protect their businesses they seek a quiet profile, camouflaged, if possible, to limit the risk of interference. This has proven critical to their survival but limits their potential to move from small to medium sized enterprises. The challenge is to incite businesses to shift towards the formal sector and benefit from proper legal protection (having first ensured the legal framework is there to do so). With little evidence of success in this area, it is one of the most significant bottlenecks constraining improved service delivery in slums in peri-urban areas. The argument that formality and collateral lead to access to finance is difficult to convey especially when the benefits of informality are more immediate. The formalization of tanker drivers in Lima, Peru provides an example of a process that has, on balance, brought about benefit for the informal providers. Tanker drivers have seen gains in their new-found ability to access credit and markets for expansion. But in Abidjan, Cote d'Ivoire many providers have rejected the call for licensing, shying away from the burdensome requirements of financial management and taxation that comes with legal recognition of their activities. Without adequate incentive, formalization is perceived to stifle flexibility and creativity

**Mobilizing formal finance for WSS businesses.** Few SSIPs succeed in negotiating credit with formal banks, either because they can not provide the required guarantees or because their activity is regarded as a risky business, outside legal bounds. For this reason, they finance their investments and their working capital by calling upon the informal financial sector and passing these costs on in the form of higher tariffs to their poor customers. Informal sector borrowing is expensive money (real rates ranging from 2 to 3 % per month). Paradoxically, in Africa, formal banks are keen to identify borrowers in the booming urban services sector. The challenge is to establish sustainable and replicable mechanisms to unlock access to formal market-based finance by making these local private sector providers bankable, by establishing guarantees (such as long contracts and a track record with public institutions) and developing win-win agreements between large formal banks and small businesses in a rapid growth phase. The challenge concerns the development of the contract – one of the most promising tools in the quest to finance infrastructure in the water sector.

## Developing strategies for integrating local private sector activity

### Bridging interventions

This experience with small-scale independent and intermediate providers in water and sanitation service delivery over the last decade has provided utilities, governments, donors and other supporting agencies with models, experiences and practices to follow to unlock the potential of the WSS market. The actions necessary to meet the challenges outlined above can be understood in terms of one of three areas of support and capacity building: (i) with government, (ii) with the local providers, and/or (iii) in developing activities that assist in forming a bridge between the two. These types of supporting activities might be technical, legal, institutional or concerned with leadership), as illustrated in Figure 1. The bridging interventions proposed are critical to the joining up process of the formal and informal described earlier.

- a. **Technical / physical.** The separation of formal and informal systems for decades means that the development of the technical / physical interface between the two is now a field for innovation. Connecting poor areas to the network or formal supply using appropriate technologies and strategies that meet consumer demand, can result in economies of scale and perhaps optimize local private sector activity. Evidence of alternative supply solutions in Casablanca and El Alto, and bulk supply options in Abidjan, Casablanca, Nairobi and Port-au-Prince provide models of how the physical interface of different systems can be achieved.

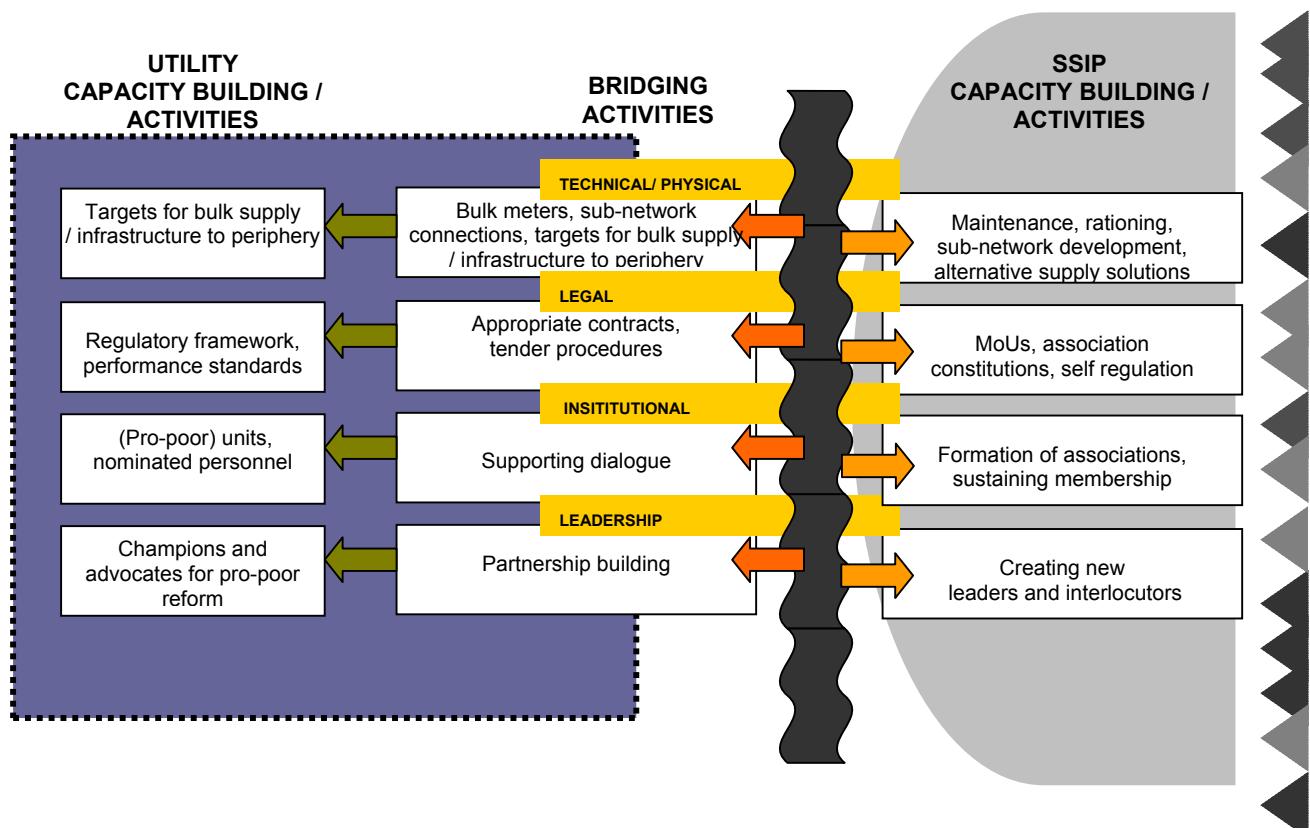


Figure 1  
Interventions supporting local private sector activity

- b. **Legal / contractual.** Creating accountability relationships between local providers and utilities, and giving them a legal status, is a key aspect of the bridge needed to join the utility with the local private sector. Much effort is needed to design appropriate contracts, tender procedures and other regulatory mechanisms that adjust to the characteristics of small water providers and accommodate formal public agencies. Examples of such innovative legal transactions can be found both for small towns (Mauritania, Uganda, Paraguay and Vietnam) and large cities (Buenos Aires, Manila and Casablanca).
- c. **Organizational / institutional.** The organizational or institutional interface between the private sector and the utility/municipality is developed by creating the communication vehicles for each

actor to interact, and the forum for the dialogue to occur. In the case of the local private sector, the vehicle is the development of associations with sustainable membership, and in the case of the utilities, successful efforts to develop pro-poor units in various cities in Africa have promoted dialogue outside conventional norms. Stimulating initial meetings and supporting dialogue are key actions to support this organizational interaction. Pro-poor units in utilities in Buenos Aires and Port-au-Prince, and professional associations in Cotonou, Abidjan and Accra illustrate the organizational change that can be achieved without significant disruption or objection.

d. **Leadership.** Identifying pro-poor champions in utilities and municipalities and interlocutors among the providers (able and willing to lead the dialogue with local authorities), are equally important steps on either side of the interface. The bridge is formed through the building of partnerships, the identification of mutual benefits gained from improving service delivery, and better understanding of the others motives and objectives.

### **What works where and when?**

With better understanding of the constraints to unlocking the water market and a set of possible solutions to test, it is necessary to consider the linkages, priorities and sequencing that results in sustainable change. Understanding the timing and content of the most appropriate package of support is essential to developing replicable models for scaling up, but the nature of this support is bound to be context specific, and begs the question 'what works where and when?' Recent experience in WSP Africa suggests that one possible framework for understanding the necessary interventions is centered on the capacity and outlook of the utility, and considers the interventions and market support mechanisms at a given point on a reform trajectory. For instance:

**Reforming utilities not focused on the poor...** Evidence suggests that for reforming utilities that have not developed a pro-poor focus the emphasis should be on strengthening the political will to target the poor. This could be achieved by focusing on strengthening consumer voice and activities aimed at developing the ability of the poor to articulate and have their views heard. In a context of sector-wide reform, a reforming utility will also recognize the authority of a regulator and regulatory mechanisms are likely to be effective in promoting pro-poor utility action. Where the local private sector has filled the gap in supply and developed a successful water market, it will be important to find ways to build the bridge between the two perhaps by developing specific entry points for support, be they technical/physical, institutional/organizational or legal/ contractual (as described in Figure 1) to provide the first steps to integrate the informal market in the delivery of WSS services.

**Reforming utilities, willing to serve the poor...** Those utilities that have shifted towards greater efficiency and financial viability and have an understanding and commitment to serving the poor, are obviously the most receptive partners. Evidence suggests that providing utilities with assistance to analyze the water market and develop better understanding of market segments, actors and potential solutions is essential as a information-sharing and capacity building exercise, and can be followed by support to scale up different strategies (e.g. (i) developing service areas for competing local private providers where the utility is not interested in delivering services; (ii) installing bulk provision where it is the most cost effective solution for the utility; and (iii) outsourcing tasks to local SSIP where it is financially efficient. These kinds of solutions will be enhanced by support for the utility and regulatory body to develop appropriate contracting of local providers; and efforts to mobilize finance for both utilities and private providers and to identify targeting options to focus public investment on low-income groups. In this situation, consumer advocacy will provide a mechanism for monitoring and benchmarking to improve performance.

**And dysfunctional utilities...?** It is likely that support for pro-poor service delivery in urban areas where the utility is largely dysfunctional, or where the state does not provide services, would focus on encouraging the local private sector to develop their services, identify constraints and develop solutions for scaling up. Somaliland provides an interesting example of the rate at which the local private sector can restore service delivery – especially when it is not struggling to work with non-market based performance standards or work around utility monopolies. The strategy in contexts where the service delivery agency is not functioning might focus on strengthening the legal and enabling framework to reduce risks for local entrepreneurs interested in investing in water and sanitation services, and then allowing the market to create a competitive, demand-responsive service.

Given its increasing role in delivering services to the urban poor, the local private sector stands as a critical component of the urban water market in developing cities. Unlocking its potential requires a series of targeted actions with a number of actors, on a number of fronts. These need to be aimed at enabling a market that is built on domestic-driven investment and activity and led by consumer demand. Developing the institutional mechanisms and practical solutions which lead to the integration of the local private sector into city strategies will be critical if MDG roadmaps are to capture the essence of service delivery to the poor.

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<sup>i</sup> This background paper has been prepared by Bernard Collignon and Janelle Plummer for the Domestic Private Sector Participation Initiative Workshop to be held in Nairobi, 20-21 June 2005.

<sup>ii</sup> The coverage rate for sanitation is even lower: only 1% to 30% of households have access to a formal sanitation service.

<sup>iii</sup> See for instance, data collected from Maputo in Hydroconseil, 2005, name of report. Unpublished.

<sup>iv</sup> The typology of local private sector providers has been discussed in length elsewhere. The starting point for this workshop is that such typologies are understood. See Collignon, Snell.....etc. WUP.