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United Nations Development Programme

POVERTY REDUCTION AND ENVIRONMENT AND ENERGY

OUTPUT-BASED CONTRACTS IN SMALL-TOWN WATER SUPPLY IN UGANDA: CHALLENGES AND OPPORTUNITIES





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Output-based contracts in small-town water supply in Uganda: Challenges and opportunities

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Cover Photo

Clean and Fresh and potable water flowing from the Mukama Water Source. The local government with support from UNCDF established a protected spring which the community takes care of. Photo by Adam Rogers/ UNDP Uganda.

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LIST OF ACRONYMS AND ABBREVIATIONS

APWO	Association of Private Water Operators
DWD	Directorate of Water Development
GoU	Government of Uganda
GPOBA	Global Partnership on Output-Based Aid
IFC	International Finance Corporation
IVA	Independent Verification Agent
MWE	Ministry of Water and Environment
NGOs	Non-governmental Organizations
NRW	Non-revenue Water
NWSC	National Water and Sewerage Corporation
O&M	Operations and Maintenance
OBA	Output-based aid
PO	Private Operator
PPPs	Public Private Partnerships
PWPs	Public Water Points
RGC	Rural Growth Centres
VAT	Value Added Tax
WA	Water Authority
WSSB	Water Supply and Sewerage Board



EXECUTIVE SUMMARY

This report presents findings from a review of the role of the domestic private sector in the delivery of urban water in Uganda. It focuses on Private Operators (POs) in small towns. POs have been operating water systems in small towns under management contracts in Uganda for over a decade. In 2008, an output-based aid (OBA) scheme was piloted in selected towns.

Since the introduction of the OBA scheme, some towns have seen a relatively rapid increase in the number of connections, while using less public funding than under traditional management contracts. However, the research shows considerable diversity of outcomes. In addition, it is problematic to attribute the results directly to the output-based mode of aid delivery, since the scheme was associated with other modifications to the contractual framework. Among other things, a higher service fee and longer contract duration have provided incentives for private investment. Furthermore, the details of the sources of investment finance and destination of the subsidy are not as clear as proponents of OBA would suggest.

The delivery of water by POs in small towns in Uganda raises many of the same issues that have emerged in international debates on private sector participation in the delivery of water. Among other things, challenges include weak regulation, information asymmetries, selectivity and short-termism. Furthermore, replication elsewhere is unlikely to be successful without consideration of the underlying structural and institutional reform conditions in Uganda. In particular, strong capacity within the Ministry of Water and Environment (MWE) to adapt the modalities of private sector engagement to changing circumstances has played a critical role.



1. INTRODUCTION

Uganda has two separate water delivery systems servicing urban areas. The public utility, National Water and Sewerage Corporation (NWSC), provides water to 23 large towns including the capital, Kampala. Outside the remit of NWSC, water provision in small towns and Rural Growth Centres (RGCs) is the responsibility of local authorities. The latter have traditionally been held accountable by the Ministry of Water and Environment (MWE) by means of a Performance Contract. Since 2000, one of the conditions of the contractual framework has been that the local Water Authority (WA) subcontracts water system management to a Private Operator (PO). Within the past five years, a further innovation has been introduced in some small towns with the piloting of a contract modality funded by output-based aid (OBA).

The Global Partnership on Output-Based Aid (GPOBA) is a partnership of donors and international organizations working together to support OBA approaches. It currently manages two urban water projects in Uganda. One targets the capital city, Kampala, and relies on a partnership with the national utility, NWSC. The other focuses on small towns and RGCs with extensive involvement of the local private sector. This report considers the impact of OBA in small towns. By way of background information, the modalities of the OBA project with NWSC are also explored as are the broader issues associated with engaging the private sector in the delivery of water in small towns.

The OBA project in Kampala is designed to provide water to low-income communities in Kampala. This is implemented through the Urban Pro-Poor Branch of NWSC, and follows a number of earlier donor-funded initiatives to reach poorer households in the capital. This OBA project funds the installation of private yard taps and pre-paid meters for public standpipes. Investments are financed by the NWSC in advance through its own funds. A pre-defined subsidy is subsequently reimbursed by the GPOBA grant, upon satisfactory expansion of the number of connections as validated by an Independent Verification Agent (IVA).

The second OBA project is a pilot programme that targets an initial group of six small towns ('brownfield' sites) and four RGCs ('greenfield' sites), which did not previously have a piped water system. Similar to the NWSC OBA scheme, the PO receives a reimbursement of its investments in the form of a subsidy only once the IVA has confirmed that the planned number of connections have in fact been installed and are fully operational.

The small-towns OBA scheme in Uganda builds on a decade-long history of formal private sector involvement in the delivery of water in the country's small towns. In some cases, the introduction of OBA has been associated with an increase in the number of connections and the speed of installation. Moreover, these improvements have been achieved at a lower government subsidy level. But there has been considerable diversity of outcomes across towns. In addition, the contract structure has been altered. The POs, for example, now receive a higher percentage of the revenue collected. This makes it unclear whether the increase in connections is the direct result of the OBA delivery model or whether it could also be that other modifications of the contractual framework have made such investments more profitable for private firms.

The findings of this research indicate that the delivery of water by POs in small towns in Uganda raises many of the same issues around private sector participation in the delivery of water that have emerged in international debates. However, the replication of Uganda's successes in other contexts and countries is unlikely to succeed without considerable attention being paid to the underlying institutional and structural conditions. The latest



policies build on a well-established history of private sector involvement in Uganda's urban water supply. In addition, these reforms have been underpinned by effective monitoring capacity in the Ministry, which has been continuously modifying the engagement of POs since their introduction.

This report reviews the role of the domestic private sector in the delivery of urban water in Uganda, focusing on POs in small towns. It is organized as follows: Section 2 provides an overview of the methodological framework. Section 3 examines the OBA project in Kampala, which is managed by the national utility, NWSC. Section 4 presents an overview of the development of the system of water services delivery in small towns, and provides a background to the introduction of OBA in small towns and RGCs. Section 5 presents the bulk of the research findings on the OBA project implemented in Uganda's small towns, and reviews the outcomes from the OBA pilot projects in relation to their official targets and objectives. Section 6 considers regulatory issues. Section 7 reviews the policy implications of the findings, and Section 8 concludes.



2. METHODOLOGY

This study combines desk research with empirical data collection and analysis. A review of relevant literature was complemented by interviews with POs, WAs and end users in selected towns. The researchers also conducted interviews with key stakeholders such as the MWE, non-governmental organizations (NGOs), head office staff of relevant private firms, and representatives of the Association of Private Water Operators (APWO).

To understand more about the nature of OBA and the background for its introduction in Uganda, the researchers conducted interviews with NWSC staff members and beneficiaries of the Kampala urban poor OBA project. Getting a thorough understanding of the OBA project for small towns and RGCs also required some background research into the pre-OBA system of engagement with POs in water service delivery. A complete review of the available literature was undertaken along with analysis of primary data in relation to water delivery in Uganda's small towns. For the Kampala OBA project, end users from 22 randomly selected households participated in two focus group discussions organized with the assistance of community leaders. Detailed data analysis of small-scale private water operators was conducted for the 79 small-town contracts. The results are presented in table 3.

For each of the eight locations where small-town OBA contracts have been implemented, surveys were conducted. This includes the six towns where contracts were originally awarded (Kachumbala, Kalisizo, Luwero, Rukungiri, Wakiso and Wobulenzi), one additional town where the OBA contract was awarded later (Busembatia) and one rural growth centre (Namutumba). In each location, structured interviews were held with POs, WA representatives and a sample of end users who have been beneficiaries of the OBA programme. Interviews were held with a total of 23 members of the eight WAs, including at least one technical officer from each town and another two members of the Water Supply and Sewerage Board (WSSB). The survey covered 100 households who had received water connections under the OBA programme.¹ The sample was selected randomly from a list of household connections provided by the operators contracted under OBA. In Rukungiri, seven out of the 15 households interviewed for the survey had yet to receive water from their connection. Effectively, the responses are therefore from a sample of 93 households. Households were asked about their water use and their views of the service provided by POs.

The interviews with stakeholders revealed some differences in opinion between the POs and the WAs with regard to the drawbacks and challenges associated with OBA. This seems to stem in part from a divergence in expectations. As far as possible, this report seeks to convey a balanced representation of the views expressed.

¹ Eleven in each of Busembatia, Kachumbala, Kalisizo and Wobulenzi; 10 in each of Namutumba and Wakiso; 21 in Luwero and 15 in Rukungiri.



3. UGANDA'S URBAN WATER SUPPLY AND THE NATIONAL UTILITY

At 67 percent, the overall level of access to safe drinking water in Uganda is higher than the regional average for sub-Saharan Africa (SSA), which is 60 percent. The same is the case for the rate of urban access. Ninety one percent of the urban population has access to safe water, while the average for SSA is only 67 percent (WHO/UNICEF, 2010). In absolute terms, budget funding (including donor support) for the water and sanitation sub-sector has remained roughly constant since 2000 at around UGX150 billion (US\$64.3 million).² However, funding as a proportion of the national budget has declined by 2.5 percentage points from 4.9 percent in FY 2004/5 to 2.4 percent in FY 2008/9. This reflects a declining priority attached to the sector (MWE, 2009). Urban water provision in Uganda, as mentioned in Section 1 is split in two. The NWSC, a publicly owned parastatal company, provides water and sewerage services in 23 large urban centres across the country, including Kampala. Service provision in small towns, however, is the responsibility of the local authority and is usually subcontracted to a PO.

Following reforms introduced over the past ten years, NWSC has become one of the most successful water utilities in the region. Part of this success is attributed to the introduction of a Performance Contract between NWSC and the government, which introduces a set of performance benchmarks (see, for example, Baietti et al., 2006). Table 1 shows recent performance data for NWSC. While non-revenue water rates remain relatively high at around 35 percent, water production has increased substantially. Collection efficiency is also close to the target. Between 2005–2006 and 2008–2009, the number of connections increased by almost 50 percent and turnover by more than 70 percent. As of June 2009, service coverage for the NWSC area was around 73 percent, compared with a coverage rate in small towns of around 51 percent (MWE, 2009).³

Table 1: Selected performance indicators for NWSC

	2005–2006	2008–2009 actual	2008–2009 target
Non-revenue water (%)	29.7	35.8	28.7
Water produced (million m ³)	58.1	70.7	64.6
Total no. of connections	152,138	225,932	244,303
Staff per 1,000 connections	7	7	6
Revenue collection efficiency (%)	90.0	101.0*	98.5
Turnover (billion UGX)	58.000	100.913	101.631

Source: MWE, 2009 (p.58).

*Note: 101 percent means collections included arrears from the previous period.

In 2008, the Government of Uganda (GoU) signed a contract with the Global Partnership for OBA (GPOBA) for a US\$2.5 million grant to fund a four-year project to support improved access to piped water services in Kampala's informal settlements. Under this OBA scheme, NWSC pre-finances the required investments to achieve the target

2 All currency conversions are calculated at the rate of US\$1 = UGX2,332 (as per www.xe.com on 6 January 2011).

3 Coverage rates are calculated by the total number of people served by all the improved sources divided by the total population. Estimates of the number of people served are calculated based on assumed numbers of users of different types of connection.



for a certain number of connections defined in the OBA agreement, using internal funds. Upon verification that the agreed targets have been achieved, NWSC is reimbursed by a pre-defined OBA subsidy. The utility uses in-house capacity and does not subcontract the implementation of the OBA project components.

Table 2: Kampala OBA project targets and achievements

	Initial project target	Achieved by September 2010	Revised project target
Yard taps	19,070	4,105	6,000
Conventional water points	205	170	200
Pre-paid meters	615	60	2,330

Source: Interview with NWSC on 28 September 2010.

Table 2 lists the composite targets established under the Kampala OBA project and the actual achievements by 2010. The figures for revised targets in table 2 reflect a change in the targeting approach, with a shift away from private yard taps in favour of public standpipes with pre-paid meters. According to NWSC, the reasons for this shift are because pre-paid meters have the following advantages:⁴

- (i) more easily installed in densely populated areas;
- (ii) more appropriate in areas of questionable land tenure, because there is no requirement for proof of land ownership;
- (iii) accessible by a larger number of people;⁵
- (iv) compatible with residents' preference for paying small amounts (pay as you go) rather than receiving a large monthly bill; and
- (v) more effective at targeting poor households, as they directly benefit from the subsidized pro-poor tariff.⁶

Pre-paid meters use state-of-the-art technology. Customers have to register with NWSC to get a token. They can buy water credit to load on their token either directly from the local NWSC branch office or from mobile vendors, who operate mobile vending machines. At the time of this research, there were 15 such mobile vendors operating in Kampala. Vendors also buy credit in advance (in bulk) from the NWSC branch office for their machines at a discounted rate of 90 percent of the tariff. This translates into a commission of 10 percent on sales. With their tokens, consumers can buy water from one of the public standpipes that have a pre-paid meter installed, at the subsidized standpipe tariff (see table 7). The system is flexible, as pre-paid meters are always open. Vendors reported that people would approach them as late as 10 pm to load their tokens.

The pre-paid meter system started as a pilot. In response to the scheme's success, NWSC has adopted it as the utility's conventional method of reaching low-income households and is currently scaling it up. The plan is to extend the pre-paid meters to other locations in Kampala as well as to other towns across Uganda. NWSC

4 Interview with NWSC on 28 September 2010.

5 Sites for the installation of the metered water taps are selected with the assistance of local community leaders.

6 Where provision is by yard tap, NWSC sells water at the subsidized price of UGX20 for a 20-litre jerry can (i.e., US\$0.40/m³), but some households were found to be reselling the subsidized water at considerable profit.



also intends to install pre-paid meters along with all future yard tap connections. Other organizations and projects working to improve water provision for the urban poor, such as the Kampala Integrated Environment Management Programme, have also adopted the pre-paid meter system.

Before the introduction of pre-paid meters, end users without a piped connection relied on public standpipes and individual yard taps for their water supply. However, in order to obtain an individual yard tap, households had to provide evidence of property ownership. The management responsibility for public standpipes was also assigned to a particular individual. Because the majority of people in informal settlements are tenants and transitory populations, they can neither demonstrate the required evidence of property ownership, nor do they qualify as managers of public standpipes. Those few households that managed to obtain a yard tap or standpipe typically ended up reselling water at prices more than four times the official tariff.

In focus group discussions, informants indicated that when the pre-paid meters were first introduced, breakdowns were frequent. This was attributed, partly, to inadequate knowledge among users of how to operate the water dispensing equipment and, partly, to deliberate tampering with meters for the purpose of accessing free water. Reports of delayed repairs were frequent. Although some NWSC technicians have been trained in maintenance and repair, the lack of availability of spare parts often causes a delay in repairs when breakdowns occur. It was reported that even where spare parts were not needed, service interruptions took up to three to four days to be fixed. In such circumstances, some people resort to the old yard taps that still exist alongside the pre-paid ones, while others turn to unprotected water sources. Overall, however, as a result of continuous sensitization campaigns, the number of people using unimproved water sources has fallen substantially. One way of reducing response time for repairs would be to train community members to carry out minor repairs.

Among the advantages of the pre-paid meter system cited by end users was that it has eliminated the problem of disagreements over bills, in particular, where these were based on estimates. Pre-paid meters have enabled people to manage their expenditure on water in a more predictable way. The view was also expressed that pre-paid meters had reduced water theft, as people with as little as UGX50 (US\$0.02) can access water. UGX50 buys approximately 40 litres — or two 20-litre jerry cans — of water. Those who cannot afford this are able to buy water credit collectively. Because pre-paid standpipes are not locked, as was the case with the old public standpipes, consumers also found that pre-paid meters enabled them to access water on a 24-hour basis. They reported that the sensitization campaign had been critical to the successful introduction of the new technology, as people had to be educated in how to use the tokens properly.

However, there were also concerns over the pre-paid meter system. In particular, customers purchasing credit directly from an NWSC branch office expressed discontent with the introduction of a minimum credit limit of UGX1,000 (US\$0.43). This was considered unaffordable by many. While water credit in smaller amounts can be bought from mobile vendors, these are still few in number. In addition, NWSC closes its offices on weekends. This means that those consumers who rely on the utility's branch offices for loading their tokens do not have reliable access to credit — and thus to water. End users also complained that the households that host the pre-paid meters usually incur the full cost of repairs when meters malfunction or break down. This sometimes led to these households attempting to pass on the repair costs to other consumers and to deny access to those who did not contribute. Together, these dynamics could lead to tensions in the community. One solution would be for NWSC to offer repair services free of charge. Alternatively, widening access to credit and improving maintenance systems promise to strengthen the poverty impact of the pre-paid meters in the Kampala.



4. THE ROLE OF THE DOMESTIC PRIVATE SECTOR IN THE DELIVERY OF WATER TO SMALL TOWNS

Outside the large urban areas supplied by NWSC, water delivery is the responsibility of local councils. This system of provision applies to approximately 160 small towns and 850 RGCs with a total estimated population of about 2.5 million (Azuba et al., 2010). Incomes are regarded as low in these towns, with only 18 percent of households having an income above US\$4 per day (MWE, 2006a).

Until the late 1990s, all formal water supply systems, whether urban or small town, were managed by the Directorate of Water Development (DWD), an agency based in the MWE. Most water sector resources were anchored at the central or regional level of government, with little involvement of local authorities (Azuba et al., 2010). This heavy centralization led to challenges in some aspects of operations. For example, revenue from water sales had to be remitted to Kampala in the form of central government revenue. This meant that attempts at securing finance for local water supply became a slow process of requesting government funding. Even if already provided for in the particular financial year budget, disbursement of funding for local water supply could take up to three months (MWE, 2010b). In those cases where such funds had not been budgeted for, it could take a complete financial year cycle to make the necessary provisions in the budget.

By the late 1990s, a reform programme supported by the World Bank and other donors set out to improve the system by separating asset ownership from system operations, and by commercializing service delivery through public-private partnerships (PPPs).⁷ Management of water at the local level was delegated to local WAs, which received financial and technical support from the MWE. However, all physical water supply infrastructure remains under the Ministry's ownership. WAs are held accountable to the MWE by means of a Performance Contract. They are contractually obliged to provide various delegated services (see annex A for more details), usually via a subcontracted PO. POs are contracted by a Management Contract to undertake day-to-day operations and maintenance (O&M) of the water supply system and other related operations.⁸ The first such contract was signed in 2001. Sanitation services have so far not featured in Management Contracts, but members of the APWO are looking into whether it could be profitable.⁹

The first procurement round for private water operators was undertaken by the MWE through a process of pre-qualification and shortlisting. Initially, eight companies were contracted to operate small town water systems. There are now around 79 small-town management contracts in operation, and over 20 contracted private operators. However, the market continues to be dominated by a small group of firms.¹⁰ Some firms have contracts with several different WAs.¹¹ Table 3 shows the allocation of management contracts for small town water supply among firms in Uganda. The largest operator, in terms of the number of contracts, the share of total water supplied and the share of total connections is Trandint Ltd., closely followed by Jowa Ltd. Between them, these two companies account for almost half the total water supply and number of connections provided in small towns. Five firms account for around 70 percent of both total water supplied and all connections.

7 Note that although the local authority is also responsible for sewerage, public-private partnerships were introduced only for the delivery of water and not for sewerage services, where there is little private sector involvement.

8 A conventional management contract can be issued for a maximum of three years.

9 Interview with APWO on 28 September 2010.

10 Fourteen of the 79 management contracts are with town councils rather than a private operator.

11 Small Towns Annual Performance Data, FY 2009/10.



Table 3: Market concentration of private water operators in small towns

	Number of contracts	% of total small towns supplied	% of total small-town connections
Trandint Ltd.	15	25	26
Jowa Ltd.	14	22	22
George & Co.	3	11	7
Kagulu Ltd.	10	8	7
WSS Ltd.	4	6	6
Other (each fewer than 5%)	19	17	22
Town councils	14	11	10
Total	79	100	100

Source: Authors' calculations, based on MWE, 2010a.

Table 4 presents details of the aggregate performance trends in small towns based on data for 70 WAs. In 2008–2009, overall non-revenue water (NRW) levels averaged 22 percent. The data also show a reduction in the average unit cost of producing water, which is mainly attributable to economies of scale associated with the increased number of connections. As a result, there has been an increase in the proportion of O&M costs covered by revenue. According to the MWE, some of the key benefits of the small-town PPP model have been improvements in the availability of performance data, improved customer satisfaction and strengthened decentralization (MWE, 2009).

Table 4: Performance data for water supply in small towns, 2006 to 2009

	2006–2007	2007–2008	2008–2009
Number of small towns	No data	69	70
Average unit cost of producing water, UGX per m ³	2,057	845	766
Non-revenue water (NRW), %	22	26	22
Annual water supplied, million m ³	2.18	2.42	3.03
Percentage of operating costs funded by revenue (cost recovery)	77	96	129
Collection efficiency, %	83	85	86

Source: MWE, 2009 (p. 62).

The remuneration system for POs has evolved significantly over time. Management Contracts have become increasingly performance-based. In order to provide an incentive to improve collection efficiency, the operator receives a percentage of the revenue collected. Under the previous system, management fees were paid regardless of revenue collected. The proportion was originally 85 percent, but has since been increased to 90 percent. The exact figure varies across contracts. In towns where the O&M costs exceed the maximum revenue from collections, an operating subsidy in the form of a conditional grant from the GoU is provided



The role of the domestic private sector in the delivery of water to small towns

(MWE, 2006a). POs charge end users for their water use at a flat rate per m³. The average tariff rate for a domestic connection is around UGX1,130 per m³ (MWE, 2010). Connection costs are subsidized by the Ministry. In all small towns, the end user pays a nationally fixed, subsidized connection fee of UGX50,000 (US\$21.4), but the real cost can be up to 10 or 15 times that amount, depending on distance from the network.¹² It has been estimated that the average cost of a connection in small towns is approximately US\$210. The balance is to be covered by the Ministry. However, GoU funding shortages have meant that WAs are reporting an increasing number of pending water connection applications.

In November 2005, the MWE, in conjunction with the GPOBA, launched an OBA programme for piped water supply schemes in small towns and RGCs. The initiative was intended, in part, to address the rising demand for water connections. Under the OBA scheme, contracts are primarily awarded for the installation of connections as well as some investment in distribution infrastructure. It also contains a management component, which assigns the selected firm with the responsibility for managing water supply in line with the existing method of engagement of POs.

The OBA scheme introduced a number of changes in the framework for contracting POs. The most significant change was in the mode of payment for investment in distribution infrastructure, including new connections. Under the original system of management contracts, any additional connection and investment costs that were not covered by tariffs were financed by the MWE in advance of the implementation. With OBA, investment has to be financed entirely by the operator up front. A specified share of the investment cost is subsequently reimbursed on the completion of pre-identified investment targets have been independently verified. This makes up the OBA subsidy.

Apart from the financing component, contracts issued under the OBA scheme differ from previous management contracts in other respects. First, under OBA contracts, firms are remunerated at a higher rate than under the traditional management contracts. They are paid a maximum service fee of 95 percent of revenue from collections compared to the previous 90 percent. Second, the contract period under OBA is longer — typically five to ten years, up from only three years under the traditional management contracts. This gives firms a longer period to earn a return on their investments, and thus, all other things being equal, provides a greater incentive to invest in infrastructure.

Finally, the administration of funds under OBA does not involve the government. Unlike other donor support to the sector, the grant is disbursed to an appointed 'Fiduciary Agent', in this case PricewaterhouseCoopers (see annex A for more information on the distribution of responsibilities among different parties). The funds go directly to an account under the control of PricewaterhouseCoopers, which then disburses the funds to individual POs, once the pre-identified performance targets have been verified. This disbursement process is far simpler and more agile than the government procedures for transferring funds. Each of these aspects of the OBA contractual framework has an impact on project outcomes.

The total GPOBA grant amounted to US\$3,207,000, financed one third (US\$1,069,000) each by the United Kingdom Department for International Development (DFID), the International Finance Corporation (IFC) of the

¹² Firms are paid 80 percent of the GPOBA subsidy when there are functioning connections and stand posts. An additional 10 percent is delivered 12 months later if water is still being delivered and the final 10 percent follows, upon the submission of a report by the MWE, stating that there are no claims on PO liability for the connections (MWE, 2010).

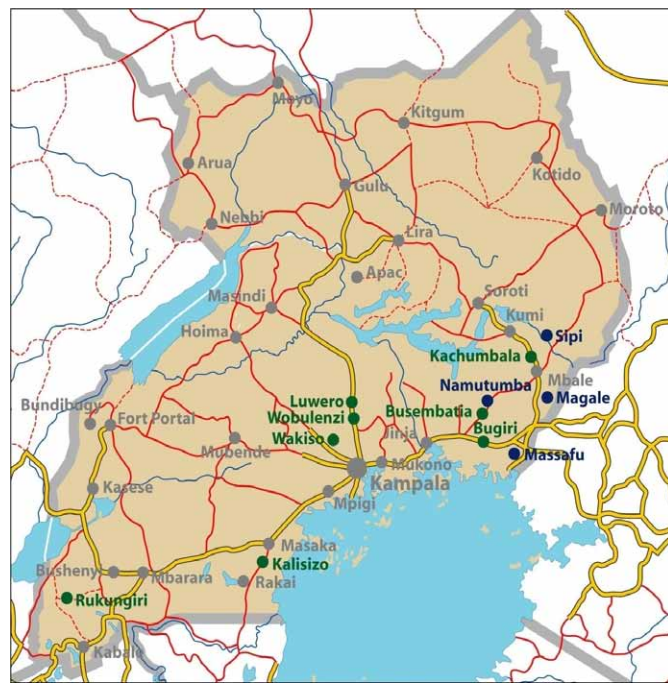


World Bank, and the Netherlands Directorate-General for International Cooperation (DGIS). The International Bank for Reconstruction and Development (IBRD) of the World Bank acts as the official administrator of the GPOBA.

Under the initial OBA pilot, a total of eight towns were selected out of an initial sample of 19 candidate towns, along with four RGCs. These 12 pilot locations are identified in bold in the map in Figure 1 below (see annex B for details of the contract awards).¹³ Their viability as OBA pilot locations was based on the following criteria: (i) targeting the poor; (ii) existing tariff levels and, by implication, the required levels of tariff adjustment for financial viability; (iii) demand and households' willingness to pay; (iv) existing water sources; (v) interest from potential operators; (vi) capacity and interest of local authorities; and (vii) status of any ongoing contracts.

In response to an open bidding process for OBA-supported water supply contracts, many firms submitted expressions of interest. Eight firms were shortlisted. Some towns were considered more attractive than others. In a few cases, only one compliant bid was received, while three or more bids were submitted for other towns. Two lots had to undergo a re-bidding in order to attract a qualifying bid. Eventually, however, bids were received for all lots that had been tendered. Three of the towns — which equate two lots as two towns were bid together in a single lot — received bids of a zero subsidy. This means that firms would self-finance all investment costs in advance and recoup the cost of this through their management fee rather than through the OBA subsidy. OBA contracts were signed between the MWE, local WAs and the contracted POs between October 2008 and December 2008, with the exception of Rukungiri for which a contract was not signed until early 2009 (MWE, 2010b).

Figure 1: Location of OBA projects in Uganda's small towns and RGCs, 2008–2009



Source: MWE, 2006a.

¹³ Two of the towns (Bugiri and Busembatia) had existing contracts that did not expire for a couple of years. These towns were therefore not included in the first pilot phase (MWE, 2006).



5. RESEARCH FINDINGS

Overall, there is considerable diversity in the outcomes from subcontracting water services delivery to POs in general, and specifically, under the OBA scheme. Some OBA contracts have run smoothly (Busembatia, Kachumbala, Kalisizo, Luwero, Namutumba and Wakiso) and some have been associated with extreme difficulties (Rukungiri and Wobulenzi). The most straight-forward cases are those where everything rolls out as predicted. The more challenging cases are those where circumstances turn out, during implementation, to be different from those anticipated during the bidding stage. The diversity in experiences seems to be less related to the nature of the firm. Rather, the same firms are represented in the best and the worst of cases, indicating that what matters more are the circumstances under which the contract is being implemented.¹⁴

Table 5: OBA contract details for selected small towns and RGCs

	Busembatia	Kachumbala	Kalisizo	Luwero	Namutumba (RGC)	Rukungiri	Wakiso
Operator Name	Trandint	Trandint	WSS	Trandint	KI-K JV	WSS	Job JV
Construction cost (UGXm)	632	121	109	138	1,091	193	167
O&M cost* (UGXm)	214	161	516	380	761	546	215
Total contract value (UGXm)	846	282	625	518	1,852	739	382
Subsidy (UGXm)	543	98	1250	1,320	1,845	80	1,500
Tariff (UGX/m ³) (excl. 18% VAT)	1800	1200	391	890	N/A	1500	488
No. of existing connections	250	75	13	5	0	546	8
No. of existing public water points (standpipe or kiosk)	0	0	0	0	0	10	0
Targeted number of additional connections	400	152	150	250	275	200	300
No. of connections completed at the time of research (Oct. 2010)	200	158	150	250	275	180	300

Source: Authors' calculations based on interviews and final contracts reviewed.

*Note: The O&M cost is a total of cumulative cost over the five-year contract period and does not necessarily involve an upfront investment by the PO.

Table 5 provides details of each of the seven small towns and one RGC informing this research. Of these eight locations, four water supply contracts are being implemented by a single firm (Trandint Ltd.). The table shows that there is considerable variation in the size of the contracts that were tendered and in the cost profile of the projects. The OBA subsidy only covers investment costs. O&M costs, on the other hand, are expected to be covered entirely by the PO from revenues. For example, in Kalisizo, a large proportion of costs are O&M costs (82 percent) compared with Busembatia where the figure is close to 25 percent. Overall, the lower subsidy

¹⁴ One firm indicated that while it has managed to install 223 new connections in one town within the span of two months, in another, it has been unable to set up 200 new connections in two years.



bids were associated with towns where investment requirements are primarily in the form of connections and piping extensions (such as in Kalisizo), because these are expected to positively affect sales and profit. This compares to, for example Busembatia, where investment requirements contain a higher proportion allocated to water production and storage.

As stated above, the essence of the OBA programme is that the service provider is paid only upon the delivery of concrete and pre-identified outputs. According to a publicity poster for OBA in the small town of Rukungiri, “if the water provider [in this case, Water Supply Services Ltd.] does not deliver specific outputs, it won’t get paid. This new type of contract is known as OBA.” While the scheme ultimately aims to increase access to safe water, a review of relevant documentation (MWE, 2006a and 2010b; Azuba et al., 2010) indicates the following intermediate objectives for OBA: (i) improved efficiency and reliability of supply; (ii) lower costs through competition; (iii) increased financial sustainability; (iv) more optimal risk allocation between the public and private sectors; (v) improved targeting; and (vi) less corruption through improved clarity and transparency. These features are considered individually below.

5.1 Efficiency and reliability of supply

This section considers efficiency in the implementation of the OBA programme and, specifically, in the delivery of connections. It also discusses the overall reliability of the system under OBA. According to a number of private firms, the success of the OBA programme was heavily dependent on the system of financial management that circumvented the state bureaucracy. By implementing the programme through a private Fiduciary Agent, the need to observe government bureaucratic processes for the disbursement of funds was avoided. This reduced red tape and increased the pace and flexibility of the disbursement process. The MWE would like to scale up and roll out the programme, but it is likely that a future scheme may not benefit from similar beneficial financing mechanisms.¹⁵ For example, the World Bank recently shifted from offering governments direct (off-budget) financing to providing funds through general budget support.¹⁶ Without the unique structure arranged for the pilot project, the institutional sustainability of future projects might be questionable.

While the financial process involving a third-party Fiduciary Agent did indeed speed up the implementation process, however, some contract awards were still extremely slow. Particularly, delays were noted between bid submission, evaluation, award and contract signing. Firms, in some cases, had to wait for up to a year between submitting their bids and the start of the contract. By this time, the condition of the water supply infrastructure was rarely in the same state as that on which the initial bid was based. Among other things, fluctuations in the price of diesel represent a significant source of cost volatility. This is the case, particularly, for projects that rely on borehole water. Increasingly frequent power outages force providers to rely on generators to maintain continuous water supply.

OBA is generally considered to be a success in terms of efficiency. It has been associated with large reductions in the public subsidy per new person gaining access. The value of such subsidies has fallen substantially in small towns, but less dramatically so in rural growth centres (see table 6). This has been described as ‘higher investment efficiency’ (MWE, 2010b, p. 29). However, while OBA may have been associated with efficiency

¹⁵ Funds disbursed under the off-budget approach are not subject to sector ceilings imposed by “Ministry of Finance Planning and Economic Development (MoFPED).

¹⁶ Interview with the MWE on 29 September 2010.



gains, the data only convey that there has been a reduction in public spending per new connection. It does not necessarily indicate that there have been improvements in efficiency. Rather, the cost of providing a new connection is being met from alternative sources of funding. In addition, transaction costs (i.e., advisory and financial intermediary costs) are higher for OBA, when compared with traditional contracts (12 percent compared with 4 to 8 percent of the subsidy) (MWE, 2010b).

Table 6: Subsidy per additional unit of access (US\$)

	OBA pilot	Traditional projects
Extension projects	7 (range: 0-36)	81 (range: 30-138)
Greenfield projects	96 (range 83-108)	135 (range: 37-250)

Source: MWE, 2010a and 2010b.

Note: These data were compiled before the eighth contract, Busembatia, was awarded.

Under OBA, output delivery, such as the installation of connections, has been faster than before (MWE, 2010b). Since revenue is proportional to the number of active connections, firms face an incentive to establish connections sooner rather than later. Financially, the private sector has proven to be more agile in this regard than the public sector. Firms disburse funds as required, without the need to observe lengthy and complex bureaucratic processes. The end user survey found that the processing time between paying for a connection and getting the tap installed varied extensively. When excluding two locations, Luwero and Wobulenzi, the average processing time was reduced from just under two months to as little as two weeks.

WAs generally agreed that the OBA programme has resulted in a faster increase in the number of connections, fewer complaints and improved revenue collection. In some cases, the reliability of water supply systems has also improved. Furthermore, there is evidence that the private sector may be better placed than a public utility to ensure the payment of arrears accumulated by politicians.¹⁷ Despite these gains, the problem of inadequate water supply persists in most of the research locations, and water rationing is therefore still widespread. Water scarcity is the main concern mentioned by the WAs. An increasing number of water ‘entrepreneurs’, who store water when it is available in order to resell it when the taps run dry, has emerged.

Many of the complaints recorded in the end user survey relate to the persistent unreliability of water supply. Only a small minority of the end users interviewed for this study were “very happy” with the service they were receiving. The main complaint was the lack of reliable supply. This is particularly acute in one town (Rukungiri), where, several months after the installation of connections, some customers had still not received a single drop of water. But water shortages were a problem in all eight survey locations, and consumers faced frequent supply interruptions. For example, in Kachumbala, customers reported lengthy breaks in supply, sometimes for as many as 20 days in a single month. This was primarily ascribed to water production problems.

End users made a number of recommendations to improve the reliability of supply, including increasing the use of generators to mitigate service interruptions arising from power outages as well as directing more investments towards the development of boreholes and other groundwater sources. Customers are calling for additional investments in the expansion of water supply infrastructure and for the installation of storage

¹⁷ In one town, the local WA, which had been running the water system in the period prior to the implementation of the OBA programme, had been unable to disconnect the water supply for a local politician, who refused to pay. However, the private firm was able to do this, in order to enforce payment.



facilities for rainwater harvesting. While the OBA scheme has brought some investment to increase the number of connections, the more extensive investment required to increase the supply of bulk water in the areas surveyed is still lacking. This can partially be explained by the incentive structure for POs, whereby bulk water production has no direct impact on the revenue of firms (see sub-Section 5.3 below on finance).

5.2 Competition

OBA is intended to result in ‘least-cost solutions’ and this is to be achieved via competitive tendering. Once a contract is awarded, the PO is effectively a monopoly supplier and any benefits from cost reductions will largely be retained within the PO to increase profits. The tendering process, then, is important in order to generate competition for the market to compensate for the lack of competition in the market. Although the market is fairly concentrated (see table 3), according to interviews with head office staff of operators as well as government, the tendering was a genuinely competitive process. Firms also cooperate with each other. Yet, as mentioned above, some towns received three or more bids while others received only one, and two had to be re-advertised to secure qualifying bids. The degree to which the tendering process has been competitive varies. In interviews it was reported that operators are more interested in serving towns that have a good supply of surface water; where there is modern infrastructure and few alternative water sources exist; and where local residents have sufficient income to afford reasonably high water consumption levels. In theory, the bidding process should lead to some kind of equilibrium where less attractive towns are bid at a higher subsidy than more attractive ones. In practice, however, even the payment of a large OBA subsidy may fail to be adequate compensation for the challenges of weak groundwater supplies and a poor customer base. In future tenders, one way to mitigate cherry-picking would be through a more appropriate clustering of towns, as proposed by the Ministry.

Competition is intended to lower the contract price (and the amount of subsidy the government pays) by getting the best value for money from the PO. Tenders are awarded on the basis of the lowest adjusted subsidy required. But the tendering process fails to adequately determine whether bids are properly grounded in local circumstances. Furthermore, the process fails to assess if the investment proposed is financially feasible or whether the firm has other activities or financial commitments that could undermine its ability to fulfil the terms of the contract. In the race to secure contracts, some POs overstretched themselves financially (MWE, 2010b and see discussion on regulation in section 6 below). Interviewees reported that some operators would get the contracts first and then renegotiate the requirements later, without undertaking a proper evaluation of investment needs *ex ante*.

The longer time-frame of OBA contracts is generally considered to be beneficial for service quality.¹⁸ On the one hand, this mitigates the problems of losing continuity and institutional memory associated with a system of short contracts (MWE, 2009). On the other hand, however, longer contracts also introduce a higher potential for moral hazard. While competition is intended to lower costs, once the contract has been awarded there is a risk of complacency on the part of the PO. One example of this is that POs tend to deploy low-level staff on the ground despite the strong technical teams presented in their bid proposals (MWE, 2009, p. 62). The extent to which this affects project outcomes is not known. But, such practice represents a clear discrepancy between the tender specifications and actual implementation.

¹⁸ At the time of this research, the MWE had adopted five-year standard Performance and Management Contracts for the small towns water subsector.



The management of water supply by POs was found to be more efficient in terms of unit costs in the initial phases of implementation. With time, however, and for various identified and unidentified reasons, costs continued to rise (MWE, 2006b). The rise in implementation costs over time could be taken to suggest that greater effort is applied in the earlier stages of contract implementation. Alternatively, it could be considered an indication that POs, once they have secured their contract, exaggerate subsequent operating costs in their business plan to put upward pressure on tariffs. This in turn increases their management fees. Thus, while competitive tendering may result in lower cost bids, longer term benefits can only be sustained with effective regulation (see Section 6 below).

5.3 Financial sustainability

OBA is intended to improve the financial viability of water supply to small towns. This includes mobilizing alternative sources of finance for the subsector (MWE, 2006a, p.5). Firms are required to raise their own funds for financing investments in advance. Once a predetermined set of implementation targets have been satisfactorily achieved, the firm is then reimbursed a pre-agreed subsidy. Some POs financed their upfront costs by borrowing money at the prevailing (high) commercial interest rate, ranging from 24 to 30 percent. Some banks required extensive collateral, often asking firms to use the property of the company as security. Providers that were unable to qualify for a bank loan raised finance via other means, such as securing credit with their suppliers.¹⁹

The situation was reported by some operators to have changed, after the Access to Finance intervention by the International Finance Corporation's (IFC) under the Small Scale Independent Provider Programme. The IFC offered training to commercial banks, in order to help them to better understand the business of water supply. This intervention resulted in a slight lowering of the interest rate to 22 percent, and allowed POs to use their OBA contract as security for borrowing. Participation in the OBA scheme was restricted to firms of a size and with security sufficient to allow them to borrow from banks. Because the success of the scheme largely relies on a predictable business environment and robust financial sector, however, the framework may not be replicable elsewhere, particularly in fragile states and economies.

The OBA scheme effectively raised funds from the private sector for investment in water in small towns. The amounts that were to be reimbursed to POs upon completion of specified outputs in small towns are shown in the 'subsidy' line in table 5. This amount equals the bid value submitted by the PO. Firms typically bid a price lower than the cost of the investment (see the 'total contract value' line in table 5). This means that the firm would finance the difference with internal funds. In three towns, OBA projects were implemented with a zero subsidy. In these cases, the private sector leveraged additional funds for investment using commercial borrowing and internal sources. But since these funds are eventually recovered through user fees, it is end users who end up paying the investment cost — including a margin for profit to the PO as well as interest to the financial sector.

Under traditional management contracts, investment was financed directly through the central government budget, and O&M costs were covered by conditional grants disbursed by the MWE on a quarterly basis to eligible towns. This means that financing came from general government revenue (taxes and donor funds). The

¹⁹ Among other things, suppliers to POs provided construction services, materials and other chemicals for water treatment.



introduction of OBA has meant a shift of the burden of financing from the general taxpayer to the specific end user in small towns. Effectively, therefore, OBA operates like a system of cross-subsidies mediated by the private sector. Given that the average resident of small towns is considered to be poor (see Section 4), having end users finance investment arguably does not constitute a progressive funding mechanism, when compared to general taxation. In addition, firms are paying commercial rates of interest to private banks to borrow funds.

Despite the explicit connection targets defined in the OBA contract, coverage remains low in some project towns. Under OBA, the tariffs in small towns are set to cover 10 to 30 percent of the expected investment costs (primarily connections and some distribution). Under traditional contracts, tariffs were not assumed to cover investment (MWE, 2010b). In Wobulenzi, for example, the water supply system was initially designed to serve 10,000 people, while the population at the time of this report was estimated at 30,000. One WA has actively discouraged households from applying for connections because the system is producing insufficient water to provide a reliable supply. In order to ensure reliable water supply, considerably more investment is required in infrastructure to increase water production capacity than has been provided under OBA.

The MWE requires each local water supply system to be self-sustaining. At the same time, systems are ageing and the production capacity is small. Meanwhile, the population is growing. The current OBA design, however, does not address the issue of water production capacity and associated interruptions and inadequate supply. There are no conditional contractual incentives to encourage long term investments by the private sector. The PO is remunerated on the basis of units of water sold and associated revenue collection. The incentive is to sell as much water as possible. If all goes smoothly, the PO can establish the required, say, 200 connections in the first year and then go on to receive almost all the revenue from these for the next four years.

This also means that the present contract design is devoid of considerations of environmental sustainability. There is no incentive to encourage water conservation or the use of alternative water sources, such as rainwater harvesting. As a means of regulating and protecting water sources, there are provisions for water extraction permits in the performance contract. But, none of the survey locations seemed to be compliant with this provision. The incentives created by the current contract design, means that the focus of OBA inevitably becomes on the short-term output of increasing connections.

The one aspect where private finance offers an advantage over public sector funding, however, is in its agility. A private firm can borrow money and quickly divert it to alternative activities in response to business opportunities. The public sector, on the other hand, has to observe lengthy bureaucratic processes. This entails a risk that the benefits of a lower cost of finance become swallowed up in the cumbersome practices that have to be observed. These are the tradeoffs that need to be carefully considered by policy makers.

5.4 Risk allocation

OBA publicity emphasizes that firms are paid only upon the satisfactory achievement of outputs. OBA is, therefore, also known as results-based aid. The output or result in question is the reliable delivery of water to end users. The presumed implication is that OBA shifts the bulk of risk associated with service delivery away from the public sector towards the private sector. The issue of risk transfer is, however, more nuanced. This is particularly the case where risks are unanticipated or where the private firm's output is to some extent reliant on capital investment by the government. According to Azuba et al. (2010, p.4), Uganda's experience



demonstrates that “by shifting performance risk to the private service providers, the project had increased accountability for results and efficiency. Moreover contrary to the view that the private sector had no appetite for risk-taking in the water sector, the pilot had shown that relatively small private companies were willing to take on pre-finance and performance risk and had strong incentives to roll out improved service quickly”.

Under the traditional management contracts, firms primarily faced performance risk stemming from the fact that their remuneration was based on tariff collections. The more water they sold, the more revenue they earned. They were also required to carry out all aspects of O&M. Under OBA, firms face increased risks. They are contracted to install a number of connections and have water flowing through them. This means that firms bear both some investment and demand risks. In reality, though, demand risk was usually not a problem, as there was substantial unmet demand in all except one town in the study. Moreover, water supply is provided by means of largely government-funded infrastructure. More substantial investments are, therefore, the Ministry's responsibility.

While OBA transfers some of the investment risk to POs, local authorities continue to face other risks. The risk of non-performance by the firm, including the firm's solvency, for example is increased where there are greater financial demands on the firm at the contract start. A firm's solvency is not just based on the local operation but on its broader activities. This means that a specific town could be at risk because of the financial vulnerability elsewhere in the firm's portfolio of operations. This risk could be lowered by strengthening regulatory capacities related to monitoring the activities of private water operators on a *national* rather than a *local* scale.

When operations proceeded as planned, risk allocation was straightforward, but where unexpected events emerged, both operators and the authorities were unclear as to which party should bear the risk. Operational risks are primarily associated with rises in fuel prices and lower than expected levels of groundwater. Under the terms of the OBA contract, POs are required to provide water continuously. Because main grid power outages are increasingly frequent, this forces providers to rely on generators. Fuel is subject to high price volatility and prices sometimes reach much higher levels than those assumed during the bid preparation period. It is not clear who should bear the extra cost — the PO, the WA, the Ministry or the end user. Under traditional management contracts, fuel cost increases were paid for by the government in the form of an energy subsidy. Under the OBA scheme the cost is in principle borne by private firms. The contracts, however, include a provision, which allows for increases in the price of key inputs (such as fuel) to be passed on to the end user via tariff increases. Despite this, so far, no PO or WA has implemented this measure.

Contract performance has also been affected by the absence of groundwater. Two operators said that low water production in the area meant that supplies had to be rationed. This was extreme in the case of the town of Rukungiri where a major water shortage occurred soon after the start of the OBA contract. The PO, WSS Ltd., had carried out investment at a cost of around UGX 70 million, but disbursement of the OBA subsidy had been delayed because there was no water running in some of the taps. There was apparently little point in adding further boreholes to the existing four, because all the boreholes shared one underground water source. Rather, a completely new source was required, and this had to be financed by the government. Meanwhile the PO has been losing money resulting from the combination of inadequate revenue from sales and the delayed reimbursement of the OBA subsidy. In this case it was more profitable for the operator, WSS Ltd., to operate under a traditional management contract than under OBA. But, had Rukungiri not suffered from low



groundwater levels, WSS could have earned more under OBA than under a traditional contract because of the added number of connections combined with higher revenue capture over a longer time period. In summary, under OBA, firms can win or lose on a bigger scale.

Workers in the system of private water supply contracts have little job security. This is in contrast to employees of the public water utility, NWSC, where workers' interests are represented and protected by a union. Workers in small towns are rarely unionized and are usually employed on temporary year-long contracts. It was reported that the operator in one of the towns had not paid staff at the branch level for several months. While workers have rights under Uganda's Labour and Employment Acts, weak enforcement makes those working in small businesses vulnerable, particularly when firms face financial constraints.

Although, there are contractual measures to address the above mentioned risks, the available contractual tools are rarely translated into practice. This is partly because of local political pressures, in particular with respect to tariffs. As mentioned above, there is provision for a tariff pass-through on input costs — but this has not yet been implemented. In addition, the WA is entitled to apply sanctions if targets are not met. In the event of less than continuous water supply, the authority can withhold the management fee from the PO. But, while intermittent supply is widespread, this sanction is only rarely applied.

5.5 Clarity, transparency and anti-corruption

OBA is intended to increase transparency and efficiency in the use of disbursed funds and thus in the allocation of subsidies (MWE, 2010b). However, the process of financial transfer under OBA is neither entirely efficient nor transparent. The programme is indeed reported to have achieved a large reduction in the government subsidy, when compared with traditional management contracts (see table 6). But, why is this? If the subsidy amount paid under the OBA scheme to finance connections is significantly less than the actual cost, then where, exactly, is the extra money coming from and how is it allocated?

In cases where the cost of investment exceeds the subsidy request, the difference is borne by the private firms, themselves. They tend to raise funds mainly via borrowing from commercial banks or by tapping into retained earnings. Where firms submitted a 'zero subsidy' bid (see table 5) this was usually based on the expectation that they would collect sufficient revenue from tariffs to finance the agreed investment target for connections.

It is important to note, however, that a firm's revenue is made up, primarily, of the tariffs paid by end users, either within a specific small town or possibly from operations elsewhere. Where the firm covers some or all of the investment costs with internal funds, these have initially been generated from user fees. Thus, the shortfall between the construction costs and the subsidy, upon which the contract was awarded in the first place, is ultimately paid by end users via tariffs. Connection costs are, therefore, effectively financed by a cross-subsidy, either within a particular town or across multiple towns operated by the same firm. This way, the OBA scheme serves as a form of redistributive mechanism: Charges paid by some consumers are used to finance connections for others and the equity impact cannot be known without detailed knowledge of the overall financial affairs of the operating firm.

Furthermore, it is not known how much profit private firms are making from these investments. Where a publicly funded subsidy is provided to finance assets from which a PO proceeds to make profits, then effectively



the operator is a beneficiary of the subsidy payment up to the extent of the value of asset depreciation during the period of operation. The financial sector also benefits in the form of loan interest paid.²⁰ Rather than bringing transparency into the use of funds, OBA as implemented in Uganda is opaque. It is far from clear, who exactly gets what support or where specific funding is coming from. In addition, the issue is further complicated as the production of water relies on existing government-funded infrastructure, which – owing to asset depreciation – effectively also subsidises the revenue stream of the private firms.

A further source of confusion in the OBA system is in the institutional framework. There are several institutions involved in the water sector, including the MWE, via the DWD, the Fiduciary Agent, the IVA, the POs and the WAs (see annex A for more details). The relationships between these are governed by a series of contracts. However, the practical allocation of responsibilities remains unclear and is further complicated by informal practices. For example, the WA is responsible for monitoring the PO and the Ministry supervises the WA. But, in the case of particularly challenging issues, the Ministry steps in to monitor the PO directly. This, however, happens only on an ad hoc basis. There is no regulation that provides for when a problem is deemed sufficiently complicated to warrant MWE intervention.

This study indicates that, on one level, the contracting of POs has created a more watertight distinction between water supply operations and political expediency. POs are on average more readily able to disconnect even politicians who fail to pay their bills. There is, however, still scope for political manipulation, in particular in tariff setting as well as in the allocation of scarce water resources when rationing is required. These, however, apply equally to OBA and traditional management contracts. The contractual parameters are sometimes haphazardly applied. For example, OBA contracts provide for a tariff review every six months. This could be a forum for resolving pricing issues. Yet, no such review had been carried out in any of the towns visited for this research.

OBA is intended to reduce corruption levels. The nature of the bidding process ensures that there is no incentive to inflate capital costs. Payment on the basis of clearly defined outputs is considered to be a transparent means of remuneration. However, scope for corruption remains. A survey carried out by the Water Integrity Network of 57 employees of POs found that more than half (51 percent) reported that political interference was “very common”, with a further 38 percent reporting that such interference was “common” or “fairly common” (WIN/WSP, 2009). It is not clear how the introduction of OBA has been entirely successful at removing this avenue for manipulation. Despite reports of close links between POs and the Ministry, it seems that no PO is simultaneously on the MWE payroll or has a connection to someone who is. However, even if such vested interests existed, this would be very difficult to prove.

5.6 Targeting

When the private sector is involved in water delivery there is a risk of selectivity or cherry-picking of service areas. As interviews have shown, priority is likely to be attached to customers and geographical areas that are wealthier and have other attributes that will ensure a more secure and lucrative revenue stream, such as no alternative water sources, and existing modern infrastructure. This penalizes low-income households and districts.

²⁰ In fact, the PO is described as the ‘beneficiary’ in the operations manual (2007).



In Uganda, OBA is intended to increase access to basic services for low-income households.²¹ According to the MWE (2006a), poverty is prevalent in the target areas of the OBA pilots and there are few if any relatively well-off people living in small towns and RGCs (see Section 4). The requirement that the verification agent should ensure that poor households benefit from the connections installed represents another pro-poor targeting component of OBA. In practice, however, there appears to be variation in the application of this criterion.

The WAs reported that a long backlog of connections already paid for, had built up in the period leading up to the introduction of OBA. These connections were given priority under the pilot programme. In some cases, attempts were made to steer new connections in favour of the most marginalized households (particularly in Kalisizo). Elsewhere, it was reported that the prioritization of new connections was politically motivated, rather than need-based — or even based on the order of the waiting list for that matter. Furthermore, by vesting the mandate to regulate the pro-poor nature of the allocation of connections in the IVA, contracts that were awarded on the basis of a zero subsidy (see table 5 and annex B) fall outside the scope of inspection. Where there is no subsidy disbursement, there is effectively no inspection.

Public water points (PWP) are provided for households that cannot afford an individual connection. The proportion of households relying on this type of water provision was found to be very limited (see table 5). This situation is shaped by a combination of demand-side and supply-side factors. On the demand side, households without an individual connection generally preferred to buy water from a neighbour, even where PWP were available.²² On the supply side, one PO stated a preference for supplying households via an individual connection over supplying a public kiosk. This was mainly due to the frequency of service interruptions associated with kiosks, such as the breakdown of taps. When this happens, revenue streams become unpredictable. Despite low usage, however, there is still value from installing public kiosks as the price of water sold from household yard taps is said to be lower where there is competition from PWP (MWE, 2006a).

In theory, the discrepancy in revenue potential for the private sector across towns should even out. Contracts for less attractive areas will, on average, qualify for higher subsidies. This should imply that aid gets directed towards the areas that are thought to hold the least value for the private sector. In reality, however, it appears that less profitable areas (before the OBA subsidy) attracted fewer bids (see Section 4). It is, thus, not clear that the OBA subsidy has had the desired pro-poor effect. The government's proposal to cluster a number of small towns together under a single bid for future OBA contracts may be more effective in mitigating the regressive effects of the selectivity bias (MWE, 2010b). The OBA scheme was designed to target small towns and RGCs, in part, to target the poor. Other decision factors, however, include demand and willingness to pay among end users, as well as the expressed interest of private operators. All in all, these selection criteria may in fact have skewed OBA subsidies in favour of the more affluent towns. The potential to roll out the programme to poorer towns and replicate it in other low-income countries may therefore be limited.

POs charge households a flat connection fee of UGX50,000 (about US\$21.4). Although this price is subsidized, it applies to all connections. Some POs and WAs reported that this price was not affordable for all households. In response, some households have been allowed to pay the fee in instalments, in order to ease affordability constraints. Households that nonetheless fail to keep up with payments for water are disconnected. Out of 93 responses, just five (5 percent) reported that they had had their water disconnected for non-payment. In

²¹ www.gpoba.org

²² Interview with MWE on 29 September 2010.



interviews, end users stated that they generally understood their water bill and rarely found it to be incorrect. However, according to one operator, some end users misunderstood OBA as a free service. Those that failed to pay had had their service disconnected. The operator was also planning an awareness campaign on the obligation to pay for water.

While disconnections are rare, the price of water restricted consumption levels for some households. Out of the 93 household respondents, 23 (25 percent) said that they sometimes reduced their water use because of affordability concerns, while 70 (75 percent) said that they did not. This, however, is not to say that water is affordable. Interviewees qualified their responses with such comments as “you can’t economize on water” and “water is a necessity.” The fact that they did not reduce consumption may thus suggest the effectiveness of household coping strategies, rather than reflect directly on affordability. Water consumption may already be at a critically low level and/or households may be limiting consumption of other goods in order to be able to afford water. Contrary to expectations, all except one household said they would prefer to be billed on a monthly basis rather than more frequently. Twenty-eight (30 percent) of the households interviewed reported to be engaged in the resale of water to neighbours. They usually charged a rate of UGX100 per 20-litre jerry can. This is the equivalent to UGX5,000/m³ (US\$2.14/m³).

Table 7: Tariff per m³ for different modes of water delivery

Mode of water provision	UGX	US\$
NWSC residential	1,519	0.65
NWSC kiosk/standpipe	982	0.42
OBA connection, public or individual (see table 5)	1,200 – 1,845	0.62 – 0.92
Neighbour reselling	5,000	2.14

Source: Authors’ compilation from various sources.

Table 7 shows tariffs for different modes of water service delivery. Under the OBA scheme, tariffs are set by local authorities and approved by the MWE on the basis of each individual town’s business plan. The tariff level is written into the contract with simple escalation clauses (MWE, 2010b). The cheapest tariff is offered by an NWSC kiosk. Buying water from a neighbour’s tap is the most expensive.

The official objective of OBA is to reach low-income households. But, the scheme does not apply any specific targeting mechanisms beyond the general targeting of small towns and RGCs. While aggregate data indicates high incidence of poverty, the survey found significant wealth disparities within the sample of end users. There is also evidence that some households face affordability-related challenges to maintaining water access. This points towards a need for more specific attention to access for those at the bottom of the income distribution, beyond the general targeting of small towns and RGCs in order to improve the impact of OBA for the poorest households.



6. REGULATORY ISSUES AND SECTOR GOVERNANCE

Uganda's regulatory framework for the urban water and sanitation subsectors involves a series of contractual relations. Under the current framework, the MWE regulates the WAs through a Performance Contract. The WAs are, in turn, expected to regulate the POs through a Management Contract (see annex C for details of responsibilities and legal provisions for enforcing regulation, and annex D for findings on regulation in management audits).

6.1 Regulatory capacity of local water authorities

Weak capacity constitutes a major constraint to effective regulation (MWE, 2010b). Private firms expressed concerns that the WAs did not have the capacity to engage meaningfully in decision-making regarding water supply. They reported that often only the town clerks and water officers have technical skills. Weak local regulatory capacity causes many POs to prefer to deal directly with the Ministry.

In the course of this study it emerged that there were major information gaps and that a high proportion of members of the WAs were unfamiliar with the details of the terms of the Management Contract.²³ Furthermore, there were internal divisions within individual WAs. Some members were apparently withholding information from other members, and even providing misinformation, for example, regarding which individuals had participated in the OBA evaluation. This scenario is not limited to OBA contracts and is reported as common across small towns.²⁴ Non-compliance with the terms of contract was also, in part, due to limited financial resources. For example, while provision is made in the Management Contracts for independent financial audits, none of the towns have ever carried these out.

Despite weak capacity, the WAs have had some impact in terms of monitoring. There were cases of regulatory breaches being met with sanctions. Examples include where a PO had failed to pay its own water bill or had failed to collect arrears. However, in interviews with WAs there was a sense that the MWE strongly supported the POs, to an extent which could undermine, or at least confuse, regulatory and enforcement processes. The WAs themselves indicated that they would benefit from more support from the MWE in managing management contracts, and a 'mentoring' system was suggested. Many of the current regulatory constraints also existed before the introduction of OBA. The main differences are, first, that the OBA framework requires firms to finance a greater share of investment costs. There is a risk that this could place too much financial strain on the company and plant the seeds for vulnerabilities that regulators are unaware of. Second, POs contracted under the OBA scheme receive a higher proportion of collections for a longer period of time, and so stand to gain more from exploiting information asymmetries.

²³ Some of those interviewed, including the Secretary and Chair of the WA, had not read the contract and did not know what the PO's responsibilities were.

²⁴ Ministry of Water and Environment Management Audit Reports, 2007/8 & 2008/9.



6.2 Information asymmetries

The relationship between the WA and the PO suffers from vast information asymmetries. The WA is ignorant about many aspects of the operations of the PO, as well as about the water system itself. There are also cases of poor handover by contractors. As a result, some WAs do not have ‘as-built’ system design diagrams or operations manuals for the schemes, which are necessary for effective monitoring (MWE, 2009, p. 62). The reporting procedures do not guarantee data reliability. There are also instances of information capture by the POs. Firms are far more knowledgeable about their operations than are regulators.²⁵ This study highlighted areas where regulation was particularly challenging. First, the operator’s remuneration consists of a set share of collected revenues. Total collections are to be paid into an escrow account from which the proportion due to the operator is then paid out. Operators, thus, have an incentive to withhold collections instead of banking them. This effectively reduces the payments collected by the WAs.

Secondly, it is difficult for the WA to know if the operator is accumulating liabilities that could eventually threaten sustainability of the operation. Regulation is carried out at the level of the local operations in a specific town. Each firm, however, often holds operations in more than one location. This means that the parent company may be amassing liabilities; making internal transfers; and submitting payments for taxes and inputs via their head office. This poses a major challenge for a local water board to regulate. There was concern among WAs that firms had overstretched themselves. This was a particular concern where a single firm had won multiple bids and was implementing more than one contract simultaneously.²⁶ Under the current setup, large-scale private firms are also well placed to run rings around under-resourced WAs.²⁷ There is thus a strong case for directly regulating the parent firms. The emphasis of all existing regulation, however, is on the contractual terms governing individual operations.

Finally, tariff setting is officially based on an assessment of revenues and costs. Meanwhile, politicians and others with little understanding of water management are involved in water pricing. The operator has an incentive to over-report costs in order to put upward pressure on tariffs in later negotiations. Given the low capacity of WAs, and their limited understanding of the cost variables, they have struggled to adequately interpret the data presented by POs and, thus, to implement a tariff adjustment that accurately reflects the costs.

6.3 Contractual relationships

The success of a contract often depends more on the nature of the relationship between the PO and the staff of the local water authority, than on the contractual details. Firms were asked about their relationship with the WAs. Among the five POs that responded, two ranked it as “very good/excellent”; another two ranked it as “good”; and just one characterized it as “weak.” Some firms have several contracts and are involved in a number of different towns. The varying experiences across locations led local managers of the same firm to rank their relationship with the local WA as “very good” in two towns and as “weak” in a third.

²⁵ Interview with MWE on 29 September 2010.

²⁶ One local WA auditor discovered that the PO had accumulated arrears to the electricity company of UGX15 million (US\$6,500). The firm was so financially stretched that it had to choose between paying for the installation of connections and paying the electricity bill.

²⁷ In the words of one town clerk, “they confuse us.”



While some authorities and operators maintain a cooperative relationship, elsewhere there are tensions and mutual suspicion between the two. Some WAs are very unhappy with the operators, and believe the water supply situation has deteriorated since the introduction of OBA. Yet, they feel powerless to terminate the contract. Some authorities feel sidelined, and perceive the PO as arrogant, ignoring the WA. There was a sense among WAs that the Ministry is strongly supporting — to the extent of imposing — the requirement to use private firms, and that the PO has stronger allegiance to the Ministry than to the local authority. This leads to tensions and confusion within the institutional structure of the water sector. In addition, there is a close relationship between the Ministry and the APWO, an umbrella organization that promotes the interests of private water operators. According to the organization's website,²⁸ the Association works directly with the MWE. One NGO alleged that the Association influences the Ministry on issues relating to extending water services to poor households.

The MWE is positioning itself to play a greater role in regulation in the future. A new regulation unit was established in the Ministry in 2009, with a staff of about five. The unit is tasked with monitoring contract compliance and performance of the urban water subsector. The regulatory framework and tools are currently being developed. The aim is to create an independent, centralized, regulatory team with funding from the Joint Partnership Fund. The unit will regulate NWSC as well as POs, and anticipates subcontracting a large proportion of the work. Eventually, the aim is for the regulation unit to be fully financed by a component of the tariff. Ministerial visits to small towns have been few so far. This is mainly because of resource constraints. A possible way forward could be to undertake a clustering of active schemes. Whenever there is a critical mass in a particular region, the MWE could have a stronger presence, providing both technical and regulatory support.²⁹ Regulation has so far focused mainly on the local operator. As mentioned earlier, a more integrated approach that regulates the firm at the national level would provide greater insight into the volume of user fees as well as their source and allocation.

²⁸ www.apwouganda.co.uk

²⁹ Interview with MWE on 29 September 2010.



7. POLICY IMPLICATIONS

Building on the findings in this paper, some relevant policy actions are presented below.

Learn from experiences with results-based aid: The experience of OBA in small towns in Uganda would suggest, upon a superficial review, that making payment contingent on the achievement of results has led to an increase in connections. There is growing support for disbursement of aid in this manner. However, this research shows that the impact is not straightforward. First, in Uganda, firms were driven, not so much by the aid that they would receive upon completion of the investment as by the revenue they would earn under the new contractual structure (higher share of revenue collections over a longer period of time). Second, any evaluation of such an approach is complex when the achievement of results also relies on inputs from the Ministry.

The implication from this research is that the more scope there is for the private sector to earn a profit and the more favourable the contract terms, the more they will invest in providing connections. However, without regulatory oversight, investment will be directed towards areas and connections that are considered profitable. Accordingly, the private sector can be expected to neglect investment in high cost infrastructure and poor areas. Preference will instead be given to commercially viable consumers. In addition, without adequate regulation, there is no way of knowing how much profit firms are making from their investments. Increasingly favourable contract terms for the private sector may therefore reduce the revenue available for longer-term investment.

Strengthen institutional capacity of key water sector institutions: The delivery of water in urban areas of Uganda combines a strong public utility in large towns with relatively successful engagement of the local private sector in small towns. This hybrid model of public-private water provision suggests that ownership is not the defining feature of results. Rather, the relatively good performance in both sectors reflects the capacity of the MWE. The Ministry has shown an ability to introduce reforms and policy modifications continuously in response to shifting circumstances.

Strengthen regulatory coordination between the local and national levels: The success of OBA contracts in Uganda's small towns has been achieved largely by strengthening the incentives for private firms to provide connections. Key incentives include lengthening the contract duration and increasing the service fee as well as the share of fee collections that accrues to the PO. Under the current regulatory framework, however, it is difficult for the government to assess how much profit the private firm is making. Regulating the firm at the national level would provide more useful regulatory information and protect interests of consumers in the complex risk allocation environment. In addition, local regulatory authorities lack capacity to provide adequate oversight. Policy interventions include greater ministry-level input into regulation along with a mentoring system that fortifies the capacity of local authorities to manage and regulate Management Contracts.

Apply a holistic approach to water supply and consider the role of water conservation activities: OBA addresses only a small part of the system of water delivery. The scheme has successfully increased the number of connections. However, this only increases the need for more extensive investment in water production capacity. Frequent electricity outages represent another major barrier to reliable water service delivery.



Alternative solutions such as water recycling and rain water harvesting may help narrow the supply gap caused by water scarcity. Water conservation activities, however, do not fit with the remit of the PO, whose objective is to maximize revenue collection. By focusing on a small element of the water supply system only, wider and more holistic activities may be neglected.

Ensure the systematic implementation and enforcement of contracts: The research revealed a divergence between policy and practice in the implementation of OBA contracts. For example, contractual measures to specify risk allocation were rarely observed in practice. Examples include the imposition of sanctions if water supply is not continuous or applying cost pass-throughs. Possibly the reasons behind this failure of enforcement were political in nature. Another possible explanation is that the contractual measures were considered impractical. Ministry interventions were often carried out in an ad hoc fashion, which created confusion and undermined the mandate of the WAs. While more Ministry involvement is required to support regulation, this needs to be conducted in a systematic fashion.



8. CONCLUSION

This study found that OBA has, in a number of cases, led to an increase in the number of connections in small towns. This has been carried out at a lesser cost to the GoU compared with previous arrangements. But the way in which these results are achieved is not as straightforward as some of the publicity may suggest. The findings suggest that results are not so much due to the modality of aid delivery (on the basis of outputs) as they can be ascribed to a contractual framework that ensures that it is profitable for firms to install new connections. Under Uganda's current OBA scheme for small towns and RGCs, POs retain as much 95 percent of revenue collected for a period of five years or longer. This means that the water services delivery system of each small town is effectively a private business which relies on government infrastructure for the production of water.

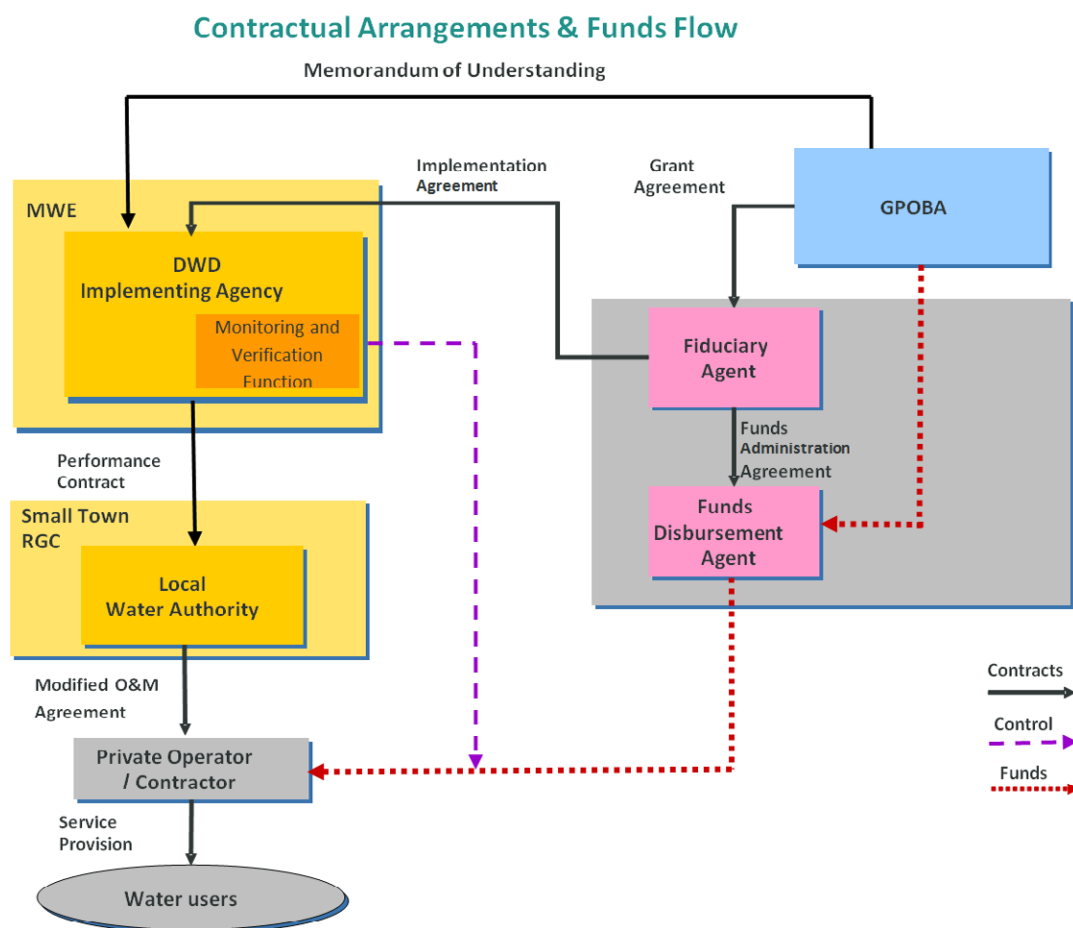
The experience in Ugandan small towns with subcontracting water service delivery to the private sector raises a number of issues that feature in wider international water privatization debates, including information asymmetries, regulatory challenges, selectivity, short-termism, and the complexities in effectively regulating local operations, on the one hand, and company headquarters, on the other. The long-term sustainability of the water supply system is threatened by a lack of investment, on a meaningful scale, beyond that which will ensure greater profit. Weak capacity at the small town level means that the public sector (i.e., the local WA) would not be a viable alternative provider at present. Weak capacity as a provider, however, often goes hand in hand with limited ability to regulate. This accounts for some of the major information gaps that persist between WAs and POs and severely curtails the quality of water service delivery in small towns. Most problematic for effective water sector governance is the fact that the exact costs and revenues incurred by the private sector in the delivery of water are largely unknown to those responsible for monitoring their activities.

The delivery of urban water in Uganda combines successful public provision under NWSC with a more sophisticated engagement with the private sector. Both elements distinguish Uganda from most other countries in the region. They also suggest that ownership is not the defining attribute when it comes to performance of the subsector. The experience with OBA in Uganda is exceptional, in that the scheme was introduced into an already well-established framework for private sector participation. It is therefore questionable how replicable the approach would be elsewhere, especially with a view to achieving the Millennium Development Goals (MDGs). Ministry staff gave a clear impression of having a strong awareness and understanding of the limitations of the current system. Accordingly, discussions are underway for designing an appropriately modified model. This model would be applied in the event that the programme is rolled out to other small towns. Since the introduction of POs as water service providers in small towns, the private sector participation system has evolved through numerous Ministry modifications. It is now firmly established. This evolutionary process observed over the past decade or so demonstrates that the Ministry has the capacity and drive to revise and adapt policy in response to changing circumstances. It is this strongly pragmatic approach applied in state activities that underlies successful water provision in Uganda — in both the private and the public sector.



ANNEX A: OBA CONTRACTUAL FRAMEWORK

GPOBA contracting was implemented with a complex set of institutional arrangements and multi-layered mandates. These included the World Bank as the administrator of the donor funds, MWE (DWD) as the implementing agency, a Fiduciary Agent appointed by the World Bank, an Independent Verification Agent contracted by MWE, and a Fund Disbursement Agent (a local commercial bank). These arrangements are represented in the diagram below:



Source: MWE, 2007

1A. Institutional and contractual arrangements

Institutional and contractual arrangements of the project were predefined in a Grant Agreement between the Fiduciary Agent (PricewaterhouseCoopers) and a Memorandum of Understanding between the World Bank and the GoU. Implementation processes were detailed in an operations manual. These relationships are explored in further detail below.



2A. Grant Agreement between GPOBA and the Fiduciary Agent

A GPOBA Trust Fund Grant Agreement was signed between the Fiduciary Agent and the World Bank. To this end, the Fiduciary Agent, as recipient of the grant, has the following responsibilities:

- (i) oversee execution of the Project, and ensure compliance with procedures and guidelines established for accessing funds under the GPOBA grant by Private Operators (Beneficiaries) in implementing subprojects;
- (ii) enter into sub-project agreements with the beneficiaries on terms and conditions acceptable to GPOBA; and
- (iii) ensure that any request for funding for a sub-project submitted by beneficiaries was in compliance with established financial management rules for submitting withdrawal applications to GPOBA including disbursement and financial and output delivery reporting and audits.

3A. Operating costs for Fiduciary Agent

The cost to the Fiduciary Agent for management of the project and administration of funds to the beneficiaries for implementation of sub-projects was included under the GPOBA grant as incremental operating costs. The costs were therefore not passed down to individual sub-projects in beneficiary towns.

4A. Delegation of project implementation functions

The Fiduciary Agent was required to delegate key implementing functions to the DWD and other agencies, including the WAs and POs. The DWD was accountable and responsible for the planning, procurement, contract negotiation and management, monitoring of output performance indicators. It was charged with verifying output delivery as well as compliance with performance indicators and the environmental and social safeguards. The latter were described in the Environmental and Social Management Frameworks and Resettlement Policy Frameworks prepared for the Project.

5A. Procurement guidelines

The DWD, on behalf of the Fiduciary Agent, carried out procurement for the Project in accordance with the provisions of the Grant Agreement and the World Bank's 'Guidelines: Procurement under IBRD Loans and IDA Credits', and the 'Guidelines: Selection and Employment of Consultants by World Bank Borrowers', both dated May 2004. The World Bank conducted prior review of all contracts and the specific methods of procurement, as provided in the GPOBA Grant Agreement.

6A. Financial viability of sub-projects

Prior to the procurement of any PO ('beneficiary' as described in the Grant Agreement), the DWD was to ensure that viable tariffs, as defined in the operations manual, were acceptable to the local WAs. The initial tariffs were included in the relevant contracts ('PSP Contracts' as defined in the Grant Agreement). The determination of viable tariffs for each sub-project by the relevant authorities was a prerequisite for the procurement of the POs. Bids were to be submitted on the basis of the subsidy required to undertake an OBA sub-project. The



subsidy was computed as the total sub-project investment cost less the investment pre-financing amount by the PO. The contract went to the firm that submitted the lowest bid (subsidy request).

7A. Financial management

The Fiduciary Agent (PricewaterhouseCoopers) was responsible for ensuring that a satisfactory financial management system was in place for conducting the functions of budgeting, accounting, record keeping, reporting and auditing. The Agent also ensured progress reports were submitted to the World Bank in time after the end of each semi-annual period, and books of accounts were prepared and submitted to the Auditor General's Office for external audit. The audited accounts were then to be submitted to the World Bank within six months after the end of the accounting year.

8A. The Directorate of Water Development (DWD) and relevant local authorities

The DWD is responsible for ensuring the following:

- (1) the relevant local and district authorities were appraised of the arrangements related to the project, and had adequate capacity to perform their responsibilities in implementing the sub-projects;
- (2) each sub-project involved a gazetted WA prior to the initiation of the tendering process; and
- (3) the relevant authorities secured agreements in writing relating to (but not limited to) the following:
 - (i) access to land required for sub-projects prior to award of contract to Beneficiaries;
 - (ii) commitment by the Beneficiary to carry out a sub-project in accordance with the guidelines and procedures set out in the Environmental and Social Management Framework (ESMF), Resettlement Policy Framework (RPF) and other relevant environmental and social safeguard documents;
 - (iii) commitment by local water authorities of timely payments of all conditional grants provided by MWE to the relevant subprojects; and
 - (iv) timely signing, on the part of both the MWE/DWD and the relevant local authority, of all sub-project agreements, including the Performance Agreement and the Enhanced Management Contract.

9A. Reporting requirements

The Operator has to submit a three-year business plan within one month of the start of the contract and this is supposed to be reviewed, updated and submitted to the authority on an annual basis. The business plan states the services and the performance indicators and targets — both financial and operational — including proposed tariffs, rates, fees and charges investment and borrowing as well as proposed disposal of assets, forecast of revenue and expenditure. One of the stipulations of the contract is that the operator shall employ personnel of at least the same skills and qualifications as set out in the proposal. Each quarter, the operator has to prepare another report for the WA with information about and analysis of its operations for the quarter and cumulatively for the year to date. The operator also has to submit a monthly report showing net billings, value added tax (VAT) and gross billings, collections for the month, VAT due for payment from and payable by the authority on account of the billings and collections for the month.

**ANNEX B: OBA CONTRACT AWARDS**

Lot no.	Town	Company	Bid price (requested subsidy) UGX (US\$)	New connections target (total)	Of which public water points	% achieved Oct. 2009
1	Kachumbala	Trandint Ltd	98,472,001 (42,226)	152	6	100
2	Wakiso	Jobatov JV	126,665,056 (54,316)	300	0	50
3a	Luwero	Trandint Ltd	0	250	0	46
3b	Wobulenzi	Trandint Ltd	0	200	0	22
4	Kalisizo	WSS Ltd.	0	150	0	50
5	Rukungiri	WSS Ltd.	97,642,557 (41,871)	200	0	4
6a	Magale (RGC)	Kol-Kagulu JV	757,213,335 (324,705)	80	14	1 st milestone*
6b	Masafu RGC	Kol-Kagulu JV	116,086,262 (49,779)	282	6	1 st milestone
7a	Sipi (RGC)	Kol-Kagulu JV	570,623,002 (244,692)	94	5	1 st milestone
7b	Namutumba (RGC)	Kol-Kagulu JV	1,112,088,308 (476,881)	275	6	1 st milestone

Source: MWE, 2006a and 2010b.

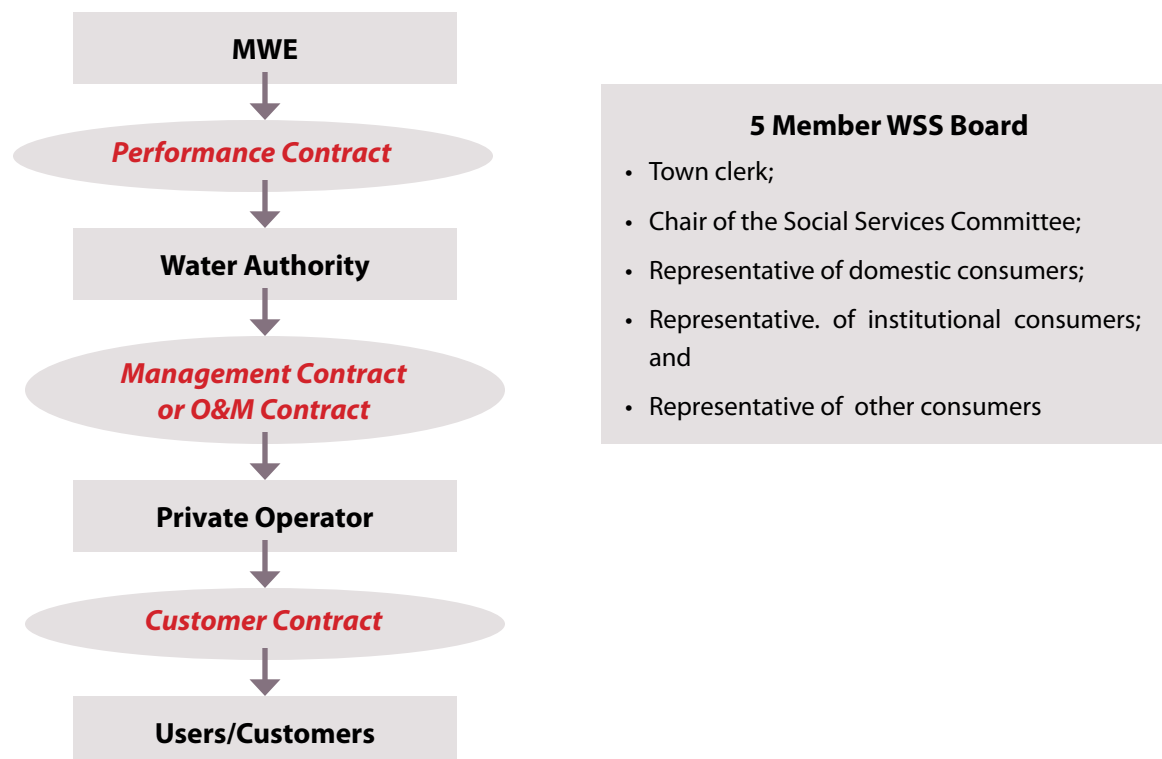
*Note: Completion of the 1st milestone means that the contractor has received a prepayment amount equal to 10 percent of the total grant. No connections have been installed at this stage.



ANNEX C: REGULATORY FRAMEWORK

Small town water systems are regulated by three-layered contractual arrangements between the MWE and the WAs, the WAs and POs, and the POs and their consumers. Institutionally, regulation is the responsibility of the Regulation Unit, which was established within the MWE in 2009. The structure for contract regulation as conceptualized with the introduction of private water operators is presented below:

Figure 1C. Contractual regulation structure for small town water supply



There is a Performance Contract between the Ministry and the WA and then a Management Contract between the WA and the PO which then has contracts with individual end users. In addition, there is a wider legal framework (Water Act Cap 152) which is the overarching law for regulation of water sector activities including water extraction, usage, waste water and sewerage disposal.

1C. Standard (non-OBA) Performance Contracts

The Minister (heading the MWE) is required (under section 48 of the Water Act) to enter into a Performance Contract with each water and sewerage authority, which must include the following prescribed information:

- the terms of reference of the authority relating to the authority's rights and obligations;
- the extent of the authority's interest in land or water supply/sewerage works constructed or financed by the government or constructed by each authority;



- (iii) the terms of reference of the authority relating to operations and functions of the authority;
- (iv) provisions of the Water Act from which the authority is exempted;
- (v) the period of the contract; and
- (vi) any other information considered necessary by the Minister for the better operations of the authority.

The Water Act gives the Minister wide supervisory powers over water and sewerage authorities. It empowers the Minister to give directions to authorities on general policy and each authority is under a statutory obligation to comply with such Ministerial directives. Each Authority has to submit quarterly reports and the Ministry may supervise or inspect the activities of an authority. The contract duration is usually either three or five years. The law also allows the Minister flexibility to enter into performance contracts of longer duration.

Under the Performance Contract the WA is obliged to constitute a five-member Water Supply and Sewerage Board (WSSB) to exercise management oversight functions including over operations sub-contacted to private sector operators. The composition of each WSSB is required under the Performance Contract for small towns and RGCs to consist of:

- (i) the town clerk/sub-county chief;
- (ii) the chairperson of the relevant local government committee responsible for water and sewerage services; and
- (iii) three other members representative of various categories of water users (institutional, commercial, industrial and household).

Members of the WSSB, one of whom must be a female, serve for a renewable term of three years. The WSSB determines its own rules for conducting its business including the election of its chairperson. The WSSB is prohibited from appropriating more than 5 percent of the gross revenues of the Authority to the WSSB's operating account for WSSB expenses.

2C. Standard (non-OBA) management contracts

The Water Authority then establishes a Management Contract with the PO which is based on the provisions of the Performance Contracts. The operator is engaged as an agent of the water authority and is bound by the provisions of the Performance Contract, including any subsequent amendments and variations. The Management Contract is usually for the duration of three years (compared to five years under the OBA scheme). This is consistent with the provisions of the Performance Contract. While the conditions of the Management Contract provide that the contract is subject to review every 12 months, it is silent on whether it is renewable. It also does not contain any detail regarding the annual contract review process. Since the Performance Contract is renewable at the discretion of the Minister (MWE) and forms part of the O&M Contract, it follows that the O&M Contract is also renewable at the discretion of the Minister. This is so regardless of whether or not the PO has met agreed service standards and targets under the O&M Contract. Some common features of Management Contracts are set out below:

- a. **Ownership:** Water sector assets are the property of the MWE and are leased to the WA for use in order to provide water to consumers. The PO has no ownership rights over the assets and cannot use the assets as loan security.



- b. **Operations and maintenance:** The private contractor is under contractual obligation to effect repairs and replacements of the water supply system, including initiating and managing extensions to the existing distribution system. The operator is required to source its own funds to effect the repairs and extensions and then to seek reimbursement from the water and sewerage authority of the costs and expenses advanced by the operator. There is provision for advance payments to the PO (by the WA) for materials and parts for approved extensions. Most WAs however do not have the funds to make such advances even when provided for.
- c. **Tariffs, fees, rates and charges:** The Management Contract mandates the PO to collect tariffs, fees, rates and charges for services. However, such tariffs, fees, rates and charges must be in accordance with the Authority's business plan, referred to in the Performance Contract. The water and sewerage authority has the right to set the tariffs, fees, rates and charges to be charged by the operator. When the O&M Contract is read together with the terms of the Performance Contract, it is implied that, while the PO is required to submit business plans, including its proposed tariff, tariff setting remains a function shared by the water and sewerage authority and the Minister alone, without the operator.
- d. **Business plans:** The PO is required under the O&M Contract to submit a three-year business plan within one month of the date of the contract's commencement. The plan must include financial targets, including the proposed tariff. The O&M Contract is modelled on the Performance Contract that requires the water and sewerage authority to prepare and submit a three-year business plan to the Minister.
- e. **Service standards:** Service provision by the PO must be in accordance with the service standards set out in the Management Contract. These mainly relate to technical service standards. The PO is responsible for maintenance and improvement of the water system including preventative maintenance, normal repairs and system replacements. While the Water Authority is entitled to appoint an auditor to audit the accounts, books and records of the PO, it is prohibited from interfering in the day-to-day management of the water system by the PO. For example, instructions on operational matters such as water connections and disconnections are prohibited.
- f. **Sole exclusive manager:** Under the Performance and Management Contracts, the PO is appointed to be the 'sole and exclusive manager' of the water supply system in the designated water supply area. However, subject to certain stringent conditions, the PO can subcontract the day-to-day management operations, as long as the necessary approvals from the WA are sought and granted.
- g. **Dispute settlement:** The Management Contract makes provision for arbitration of disputes between the PO and WA. Where the parties are unable to agree on an arbitrator, either party can serve a notice on the other party requesting the director of the DWD to arbitrate the dispute. Given the critical role played by the DWD in the funding, design, supervision, monitoring and evaluation of water and sanitation projects throughout the country, the director is likely to have a conflict of interest whenever disputes are referred to the DWD for arbitration. Many disputes might relate to findings made by technical and other staff of the DWD and the impartiality of the director which is so critical to dispute settlement is likely to be questioned.



3C. OBA Contracts

The GPOBA Performance and Management Contracts are an enhancement of the Standard Contracts that already existed in the sector. There are typically two elements to the OBA contract — the Management Contract that is the same as under the traditional contracts and a design-and-build (D&B) component. Both are part and parcel of the same agreement. The terms of the contracts under OBA are much the same as for traditional Management contracts, reflecting the Performance Contract. Assets are owned by the Ministry, even the investments implemented under the OBA programme. Tariffs are set in agreements between the Authority and the Ministry.

There are three parties to each OBA contract: the MWE (represented by Permanent Secretary), the WA (represented by the Town Clerk), and the PO (or D&B and O&M Joint Venture as applicable). This is different from the traditional contracts where the Performance Contract is between MWE and the WA only, while the Management Contract is between the WA and PO.

The other main differences between OBA and traditional contracts are that the former are subject to approval by the GPOBA. The service fee (the share of revenues that accrue to the PO) is typically higher, at 95 percent rather than 90 percent, and the contract duration is for five to ten years (compared to three years under the standard contractual arrangements). As with the traditional management contracts, the GPOBA Management Contract is based on the GPOBA Performance Contract between the MWE and the WA.

Provision is made for dispute resolution in line with the GPOBA Performance Contract. This requires parties to first try amicable settlement of disputes, and if that fails, then the parties must resort to arbitration. GPOBA specifies the Uganda Institute of Professional Engineers (UIPE) as the designated arbitrator.

In addition, it is dependent on the following legal documents:

- (i) GPOBA co-funding approval for each project town;
- (ii) Grant Agreement between the local Fiduciary Agent of GPOBA, which deals with the agreed rules of financial management of GPOBA co-funding. This includes rules for release of GPOBA funds, monitoring, audit and supervision;
- (iii) Memorandum of Understanding (MoU) between GPOBA/WB and DWD as the 'implementing agency', regarding GPOBA project planning, implementation, monitoring and supervision;
- (iv) Implementation Agreement between the Fiduciary Agent and the implementing agency, covering planning, procurement, contract negotiation, management, verification and monitoring of project output deliverables; and
- (v) Design-and-Build (D&B) contract.



ANNEX D: REGULATION FINDINGS FROM MANAGEMENT AUDITS

The MWE commissioned management audits for the years 2006/07, 2008/09 and 2009/10. The audits generally established that there were definite and specific commitments by the different stakeholders (MWE, local authorities, POs etc.) to address issues related to performance and reporting, but that there was no mechanism for tracking those commitments. Nor were there any enforcement measures in place to deter and sanction non-compliance. This lack of tracking led to a lapse that gave the parties an opportunity to treat such obligations as 'best endeavour' decisions, which means that they are only addressed at the will of the non-complying parties. From the findings on contractual compliance, it was concluded that:

- compliance was a necessary, but not sufficient, condition for efficient and effective service delivery;
- non-compliance was both by omission or commission: omission through inadequate understanding of the contracts and commission through flagrant disregard of contractual provisions;
- non-compliance was more pronounced in provisions related to financial management, auditing and reporting;
- laxity in enforcement of contractual provisions identified to have been violated sent a message of disinterest on the part of the regulator. This only encouraged further abuse by the offending parties and acted as an incentive for other WAs to disregard similar provisions; and
- the MWE had not elaborated regulations that were enforceable as remedies against contractual non-compliance. Performance and Management Contracts existed but regulations for enforcement, redress and/or penalties were not in place.



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