

Output-Based Aid in Honduras: An OBA Facility for the Water and Sanitation Sector

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Honduras has achieved a reasonable level of access to water supply and sanitation, but gaps in coverage remain, especially in rural and peri-urban areas, and service quality for those with access is often poor. To help the Government of Honduras achieve universal coverage and improve service quality, the Global Partnership on Output-Based Aid (GPOBA) is funding a project to test the viability of an innovative output-based aid mechanism for financing water and sanitation services. Housed within the Honduran Social Investment Fund, this “OBA Facility”—the first such facility funded by GPOBA—aims to improve access to water and sanitation services for about 15,000 low-income households, and to increase efficiency and transparency in sector investment funding. To be eligible for funding from the OBA Facility, projects must meet specific criteria and payments are made against verifiable results.



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Background

Honduras, a Central American nation with 7.5 million inhabitants, is the fourth-poorest country in the Western Hemisphere. While the country has achieved a reasonable level of access to water supply and sanitation, gaps in coverage remain, especially in rural and peri-urban areas. Moreover, service quality for those having access to infrastructure is usually poor. Only a small fraction of those connected to the water network receive water continuously;¹ less than half receive disinfected water;² and only 10 percent of the collected wastewater receives any form of treatment.^{3&4}

Water and sewer services in Honduras are provided by a variety of entities. The rural population, about half the total, is served by 5,000 water boards (*juntas de agua*). In urban areas, a private concessionaire serves the country’s commercial capital, San Pedro Sula; the national water company SANAA serves the capital Tegucigalpa and twenty intermediary cities; and three mixed com-

panies as well as a number of municipal companies and municipalities operate in other intermediary cities and small towns. Most connections are unmetered, and both water consumption and water losses are high. Tariffs, on the other hand, are very low, at about US\$3/month in Tegucigalpa and typically less than US\$1/month in rural areas. Such low tariffs generate barely enough revenues to recover operating costs at a low level of service quality. Some US\$262 million was invested in the sector between 1997 and 2006, to a large extent financed by external donors through a multitude of projects with different rules and different implementing agencies. This resulted in some increase in coverage, but with little transparency and without significantly improving service quality or ensuring financial sustainability.⁵

To achieve universal coverage and improve service quality, not only is a higher level of investment required,

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but local leadership, more accountable and sustainable management models, and a mechanism to ensure a more efficient and transparent use of public funding for investments are needed. The Government of Honduras made a step in that direction by passing the 2003 Drinking Water and Sanitation Sector Framework Law. The law created a supreme policy-making council and a regulatory agency and aims at transferring services from SANAA to municipal utilities over a ten-year transition period.⁶ However, the fragmented financing mechanism of the sector remained untouched by the reforms. The government's strategic plan for the modernization of the sector, published in 2005, foresaw the harmonization of funding through the creation of a Honduran Water and Sanitation Fund, which so far has not been established.

Rationale for GPOBA Involvement and Project Objectives

In this context, the Government of Honduras expressed interest in using the OBA approach, under which subsidies are paid once agreed-upon results (outputs) are verified. The project has two interlinked objectives: most immediately, improving water and sanitation service and access; and in the medium term, demonstrating innovation in funding sector investments through an efficient and transparent mechanism for financing water and sanitation infrastructure projects. The project will improve access to and quality of water and sanitation services for low-income households with an average per capita income of US\$2/day in rural and peri-urban communities.

The project is currently fully funded by the Global Partnership on Output-Based Aid (GPOBA). It has three components. Component 1 provides US\$4 million for direct subsidies to finance eligible water and sanitation infrastructure projects. Each project has specific outputs, including final working connections (either domestic water or sewerage connections or yard taps) and measurably improved water quality. Component 2 provides up to US\$60,000 to support project implementers in enhancing project designs and their capacity to implement the projects. Component 3 provides US\$390,000 for the running and management of the OBA Facility, including payment for Independent Verification Agents (IVA).

How the OBA Facility Functions

The OBA Facility is housed within the Honduran Social Investment Fund (FHIS). Project implementers

make a request to FHIS for a one-off subsidy to cover the unit cost per connection which is payable against prespecified outputs for each project. The Facility operates on a four-month cycle. Projects are evaluated for their social benefits and feasibility as they are received, and are ranked against other project applications for that corresponding cycle. At the end of each four-month cycle, projects that are deemed eligible by the specialist unit in FHIS proceed to implementation.

Figure 1 describes the project cycle and the OBA Facility's criteria in more detail. The project cycle starts when the OBA Facility receives a project application. Then the project is reviewed to determine whether the technical design and proposed solution is feasible. Next, the OBA Facility undertakes a full technical, socioeconomic, environmental, and financial feasibility review. It also determines the maximum subsidy requirement for each project subsidy based on the project's costs and tariffs (always ensuring that tariffs cover at least operation and maintenance expenditure).⁷ In no case will the proposed OBA subsidy exceed US\$117 per person for water services or US\$130 per person for sanitation services. Regardless of whether the implementer is public or private, the total community contribution needs to be at least 20 percent of the project cost.

For a project to be eligible for further consideration the Economic Net Present Value (ENPV) of the project's cash flows must be positive and the Financial Net Present Value (FNPV) must be negative. This effectively implies that projects will be considered only if they have clear social benefits and if the implementer has no financial incentive to execute the project without a subsidy.

Given the limited amount of resources available, the OBA Facility assesses subprojects according to an eligibility criteria which consists of (a) the unit cost efficiency index based on the lowest subsidy amount benefiting the greatest number of households; and (b) a comparison of the total costs of a subproject expressed on a per capita basis as compared to a World Health Organization (WHO) reference value. Subprojects are then compared against each other and ranked by the lowest subsidy reaching the greatest number of beneficiaries.

At this stage, the OBA Facility determines whether the projects that have been deemed to be eligible for financing will need additional technical assistance resources to enhance technical designs and/or local capacity by supporting specific processes during implementation.

Each implementer will enter into a Performance Agreement, which details the roles and responsibilities

Figure 1. The Project Cycle and OBA Facility Criteria

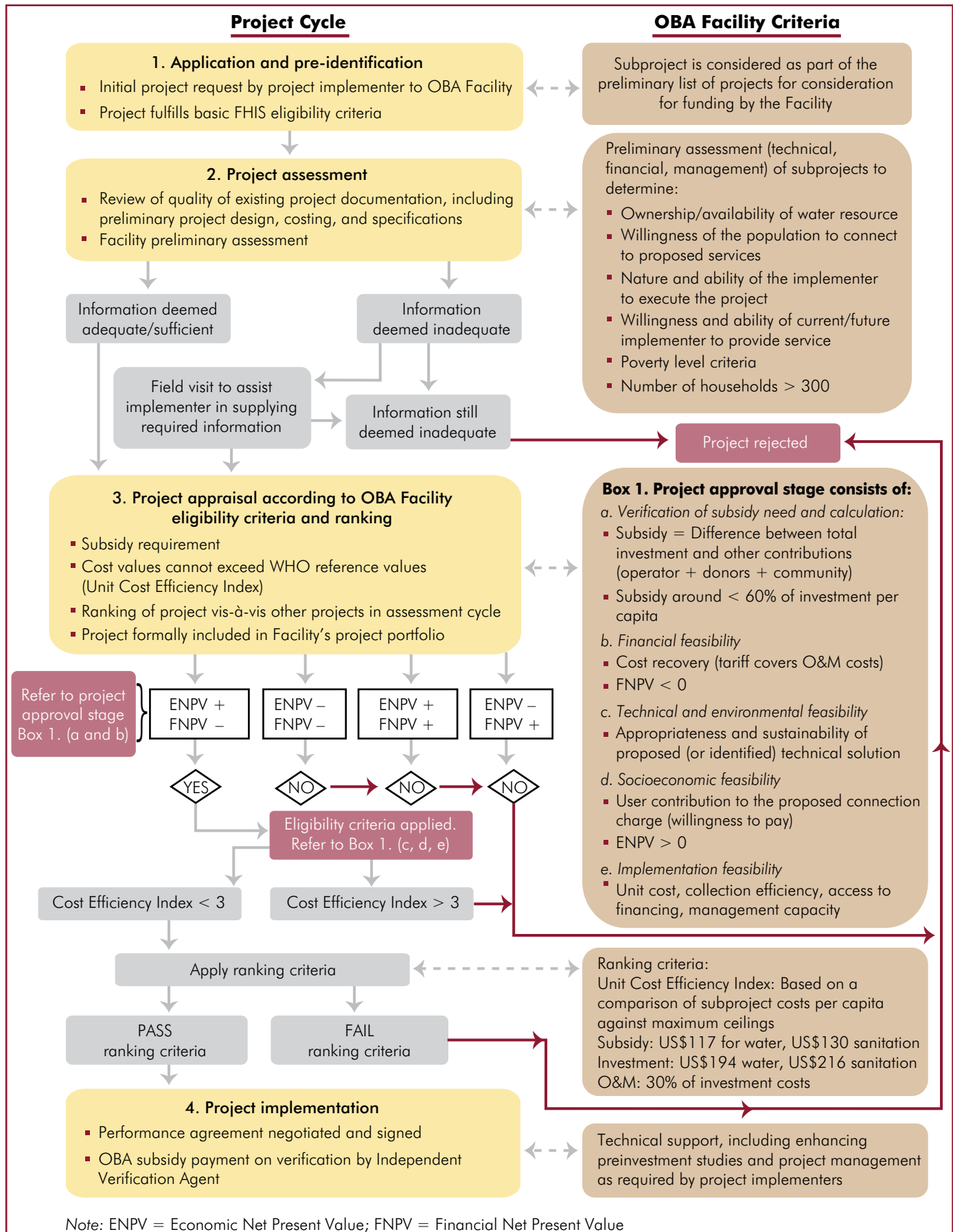
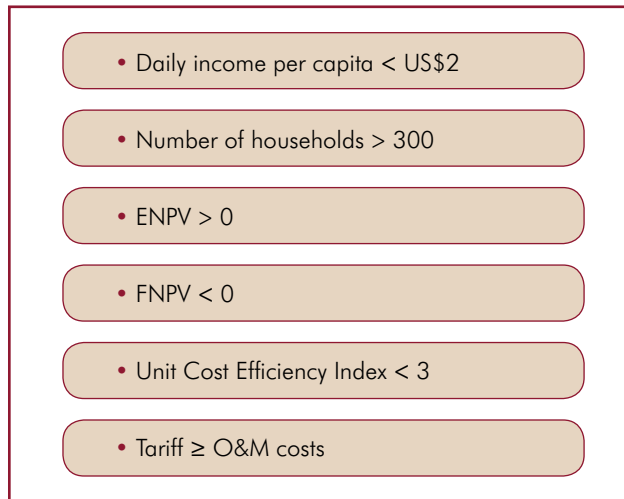


Figure 2. OBA Facility Eligibility Criteria



of the parties, as well as the indicators against which payment of the subsidy will be made. The implementer will either undertake the construction itself or outsource the construction. An Independent Verification Agent is contracted before construction begins to verify the baseline data upon which the outputs will be paid, and subsequently to verify the outputs. Subsidy disbursements are paid in three tranches: 10 percent after the contract has been signed; 65 percent after construction has been finalized and the number of new connections has been independently verified; and a final 25 percent after the project has been in operations for six months and a number of indicators for service quality and sustainability have been independently verified.

As part of the obligations set out in the Performance Agreement, each implementer must provide the following guarantees: advanced payment guarantee for the initial cash payment of up to 10 percent of the total subsidy amount; performance guarantee for 15 percent of the total amount of the construction contract during the construction period; and works guarantee for 5 percent of the total subsidy amount for a period of one year after the works have been commissioned.

The OBA Facility has funds to finance bridge loans to public implementers for preinvestment. These funds have been provided by the Government of Honduras as a revolving fund, with a balance of US\$1 million. The bridge loans are repaid by the public implementers to the OBA Facility when the subprojects have achieved the agreed results. Bridge loans are not given as a lump sum payment; instead, the payments have been structured as an initial cash

payment of up to 10 percent of the total amount, with the rest gradually disbursed according to a schedule of required procurements. The performance guarantee and the works guarantees for public implementers that outsource the construction are provided by the contractors.

Implementation of the OBA Facility in Honduras

The OBA Facility in Honduras started operations in 2008. Under the first cycle of subprojects assessment (Phase 1), the OBA Facility evaluated around twelve projects and signed two contracts with implementers, which are currently in execution. One contract was signed with SANAA grouping 12 water subprojects in 16 peri-urban areas of Tegucigalpa. These projects include the installation of meters, construction of tanks, and laying of distribution lines, payable against working household connections. The contract with SANAA, a public implementer, is for a subsidy amount of US\$0.9 million. The contract with SANAA was accompanied by a bridge loan of US\$0.63 million.

The second contract was signed with Aguas de Puerto Cortes (APC), a private implementer, for a subsidy of US\$0.18 million. The output is increased water quality to households. As part of Phase 2, eighteen subprojects with public implementers and four subprojects with private implementers were assessed and ranked. Taking into account this assessment and the availability of funds for additional contracts, the OBA Facility envisages signing four more contracts with public implementers and two additional contracts with private implementers in 2009–2010.

Results and Lessons Learned

The establishment of an OBA Facility is not without challenges. Unlike a traditional OBA project, the OBA Facility funds a number of projects with many characteristics. Some lessons learned from the implementation include the following:

- The original structure envisaged that the regulatory agency ERSAPS would act as the OBA Facility's independent verifier of outputs. However, the regulator's actual capacity (both technical and financial) is very weak. Accordingly, it was necessary to hire consultants to act as verification agents.

- The use of technical assistance funds is crucial for enhancing implementers' capacity to execute projects, particularly in the case of poor municipalities or communities.
- The eligibility methodology, as currently devised, gives an advantage to projects that are able to supplement funding from other donors or other sources. Furthermore, the ranking methodology tends to favor areas with high population density and flat topography. Giving a high weight to the greatest number of beneficiary households for every dollar of subsidy spent means that small communities are less likely to benefit from the scheme. Water service provision is more expensive for projects that require pumping; thus those projects may not be deemed eligible or may be assigned a lower ranking score.
- The increase in construction prices has made it necessary to lower physical targets and to adjust benchmark costs used to determine eligibility and rank projects. Cost increases between the time the contract is signed and the work is executed pose a significant risk to implementers.
- Establishing a more efficient and accountable way to use public money for investments in the sector will take time. In particular, donors in Honduras use input-based funding mechanisms (which do not require implementers to assume any prefinancing risk) and provide a higher subsidy for capital costs. It is hoped that through the results of the pilot OBA Facility, stakeholders—notably donors that are willing to fund investments—will progressively adopt the OBA approach to channel funds in the sector, in order to improve access and increase the service level to underserved or unserved communities on a wider scale. Using the mechanism already established by the OBA Facility for all projects in the sector would also reduce transaction costs for the government.
- It is too early to tell whether using an OBA approach as opposed to a traditional approach to funding sector investments reduces the time needed for implementation. However, this experience does suggest that setting up an OBA Facility takes time.
- The actual needs on the ground are somewhat different from what had been expected at project design. For example, the project assumed that there would be a demand for yard taps, while users actually want and are willing to pay for house connections.

Conclusions

A number of challenges have been identified when using an OBA Facility. To a certain extent, the jury is still out as to whether an OBA Facility is right for Honduras. FHIS is considering applying an OBA approach to all its funding for the sector if the pilot facility is successful; it could even be extended to all publicly funded water and sanitation projects in Honduras. The benefits of using an OBA Facility approach for water and wastewater sector investments include the following:

- The process by which projects are chosen may become fairer and more transparent, as projects are evaluated according to their respective merits and compared against one another.
- The fact that payments are linked to outputs sharpens the implementers' focus on results and improves the quality of monitoring and evaluation, since all results must be validated through independent verification agents.
- Tariffs for each project must cover at least operation and maintenance costs, in contrast to the current situation in Honduras, where many service providers barely cover their operating costs and defer maintenance.
- For public implementers, prefinancing is available through bridge loans. While this type of financing involves complex arrangements between the loan recipient (the implementer) and the government, it places responsibility on the implementer to achieve or meet the agreed results. This enhances accountability for the use of such funds.
- For private implementers, prefinancing can be arranged by tapping their own revenues or through local commercial banks.
- Some of the projects funded by the OBA Facility complement upstream investments supported by other donors. OBA Facility-supported projects filled in a critical gap in these efforts. Cases include SANAA and San Agustín, where the European Union and USAID respectively have funded water distribution trunks, but water connections have not been installed for all beneficiaries and sanitation infrastructure is still missing.

The OBA Facility also builds upon and strengthens good practices in the sector, such as the *contribución por mejoras* initiative, under which municipal governments negotiate the cost-sharing and payment ar-

rangement with community residents for the installation of new public works; as well as community work in-kind, local government involvement, and community participation in decision making.

- ¹ The figure was 2 percent in 2000, according to the World Health Organization. (*Evaluación 2000 agua potable y saneamiento en las Américas, Honduras*). This percentage has increased somewhat since then, with the cities of Puerto Cortes and San Pedro Sula enjoying continuous supply.
- ² Some 75 percent of urban water supply and 12 percent of rural water supply was being disinfected in 2006, according to *Los desafíos de los sistemas de agua potable rural*, Lino Murillo.
- ³ Personal communication, Rodolfo Ochoa Alvarez, División de Investigación y Análisis Técnico en Agua Potable y Saneamiento del SANAA, October 3, 2007.
- ⁴ To complicate matters, sector data are not reliable and sometimes conflicting. For example, according to the 2006 household survey, access to an improved source of water supply stood at 81 percent, while the Joint Monitoring Program (JMP) that tracks the achievement of the Millennium Development Goal (MDG) target for water supply and sanitation at the global level estimates access at 87 percent in 2004. The 2006 survey estimated that 86 percent of Hondurans had access to adequate sanitation, while the JMP estimates the same indicator at only 69 percent.
- ⁵ A notable exception is the city of Puerto Cortes, where since 1993 water production and access have more than doubled, water supply has become continuous, meters have been installed, service is being cut off to those who do not pay, tariffs have more than doubled, wastewater treatment has been introduced, and the first mixed-enterprise model with citizen participation in Honduras has been introduced. Sadly, the success of Puerto Cortes has not been replicated elsewhere in Honduras.
- ⁶ As of early 2009, services had been transferred to only one municipality (Siguatepeque). The original five-year transition period under the 2003 law had to be extended to ten years in 2008.
- ⁷ The proposed OBA subsidy is set by assessing the project's total investment and deducting other contributions, such as community work in-kind, land, municipal contributions, other donors' contributions, and, as appropriate, any contributions from the tariff over and above covering operation and maintenance expenses.

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OBA Approaches is a forum for discussing and disseminating recent experiences and innovations in supporting the delivery of basic services to the poor. The series focuses on the provision of water, energy, telecommunications, transport, health, and education in developing countries, in particular through output-, or performance-, based approaches.

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