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SCALING-UP SANITATION ENTERPRISES: THE ROLE OF OUTCOMES-BASED FUNDING

What are we trying to achieve?

Many sanitation enterprises working in low-income settings are, in theory, aiming for profitability. But, in practice, sanitation is a difficult business. The cost base (both capex and opex) is significant, there are significant working capital needs and customers' willingness-to-pay for sanitation services is limited.

Yet making progress towards SDG6 requires impact at scale that is sustained over the next 12 years to 2030. This raises two questions:

- How can we scale-up – sustainably – low-margin but high-impact sanitation enterprises, so that they provide services to as many customers as possible?
- And how can we orient these sanitation enterprises towards providing services for the lowest-income groups, not just those with the highest willingness-to-pay?

Some priors

We assume that innovative, scalable and high-impact sanitation solutions will be delivered by private-sector enterprises operating in the 'decentralised', non-networked sanitation economy.

- **We are not looking at high-capex investments in conventional sewerage and wastewater networks**. We are instead focusing on services that meet the needs of even the poorest customers and that harness 'circularity' principles where possible to drive down net operating costs (e.g. conversion of fecal sludge into new high-value products)
- **Our focus is private-sector service delivery**. But we recognise that the public sector in low-income countries has a vital and complementary role to play, both in establishing a conducive investment, regulatory and operating environment, and in provision of services that cannot generate customer revenues (i.e. where willingness-to-pay is low or zero).

The financing and stakeholder challenge

There are few, if any, sanitation enterprises in low-income countries that are, at the same time, high-margin, high-impact and already at scale. **Instead, our focus is on small[1], under-capitalised but innovative & high-impact sanitation enterprises.** These enterprises may have negative operating margins, minimal balance sheets, zero credit history, and limited operating track records. Unsurprisingly, these enterprises are highly unlikely to scale via existing financial market mechanisms, such as local bank lending or private debt and equity investment, even with existing risk mitigation instruments.[2]

We are hence looking at a hybrid public-private investment strategy. Specifically, this entails bringing together donor funding[3] and return-seeking social investment. This has several implications:

- We need to find a structure that (i) avoids unduly subsidizing private enterprises or distorting the market, (ii) allows donors to demonstrate maximum value-for-money for their support, and (iii) ensures low-income customers can benefit from the enterprises' services.
- A further important assumption is that **these sanitation enterprises can be sustainably profitable, without ongoing public sector financial support, when at scale.** Public sector

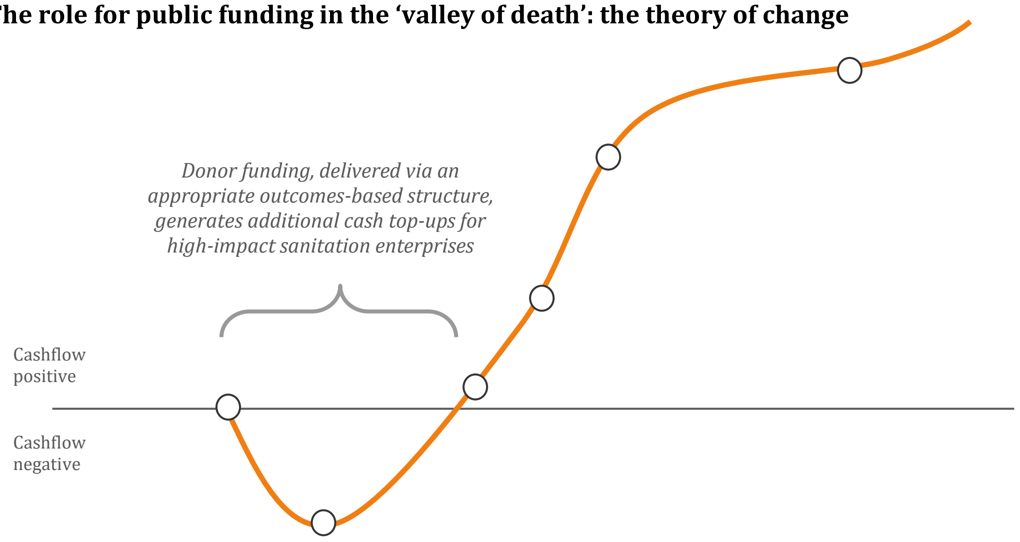
[1] Most sanitation enterprises that we are aware of in low-income countries turn over <US$1 million per year. Few, if any, turn over >US$5 million.

[2] Such as guarantees from donor-funded bodies (e.g. GuarantCo, USAID's Development Credit Authority, IFI partial risk / partial credit guarantees)

[3] Donor funding needs to be scorable as ODA, in line with the OECD's DAC guidelines on development assistance

funding should be part of a transitional mechanism that helps fragile enterprises navigate the 'valley of death' between initial start-up grant funding and the point where net cashflow turns positive, opening up (quasi) commercial investment:

The role for public funding in the 'valley of death': the theory of change



The opportunity: outcomes-based funding instruments

Innovative funding instruments can address these challenges. **Specifically, donors are increasingly using outcomes-based funding, where grant payments are triggered only when results are achieved.** As one example, **development impact bonds** (DIBs) combine (i) contingent funding of impact by donors against a pre-agreed set of outcomes metrics, (ii) external social investors who provide pre-financing for an intervention and take on the risk of under-performance, and (iii) a contractual framework that incentivises frontline service providers to track progress and adapt the intervention as it proceeds, to maximize the likelihood of success. See the appendix for more details on impact bonds.

The opportunity here is to integrate private sanitation enterprises into a DIB as the frontline delivery agent, where there is significant social benefit ("positive externalities") from that enterprise's activities, both for customers and the broader markets and communities where they operate. **If financially-marginal but high-impact sanitation enterprises are at the frontline of delivering improved sanitation outcomes, then their financial viability would be improved if they could capture some share of these positive externalities.** A funding instrument that pays out on outcomes achieved – such as a development impact bond – would generate a revenue stream for a social enterprise that, in effect, monetizes the broader social impact of that enterprise's activities. (In other words, it would transform positive externalities into a valuable cash 'top-up' to those sanitation enterprises. [4]).

> **Monetizing Impact in the Sanitation Sector: Fecal Sludge Management**
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> Households in low-income, informal settlements are often willing to pay for removal of fecal sludge from their households. But they may not be able to afford safer mechanical desludging with transportation of fecal sludge to a treatment site. Instead, they may resort to manual pit desludging with unsafe disposal, which is hazardous for the household, the manual pit-emptier and the local community. Mechanical pit-emptying and safe transportation of fecal sludge hence represent significant positive externalities that are often not captured by the market. Outcomes-based funding – for example, using metrics such as volume of fecal sludge safely delivered for treatment – could monetize these impacts.

This would be a novel source of financing for enterprise scale-up, as well as a highly efficient aid mechanism to maximize these positive externalities: a win-win. As importantly, it would not distort the day-to-day mission of an enterprise to win customers, improve cost efficiency, and grow its market.[5] Nor would it crowd out conventional investment in enterprises – in fact, it would help them move along through the 'valley of death', increasing the likelihood of scalability.

Criteria for outcomes-based funding

DIBs and other outcomes-based funding instruments are not suited to all interventions or enterprises. The criteria used to assess whether an outcomes-based funding instrument would be suitable include: (i) measurable outcomes that would allow attribution of results to the funding inputs, (ii) a reasonable evidence base for those interventions, and (iii) a feasible operational model with space for iteration and learning ('adaptive management').

Equally importantly, an impact bond does not need to be a standalone funding instrument. In fact, outcomes-based funding instruments are often best deployed as part of a more comprehensive investment program:

- For example, some DIBs are embedded in broader grant-based programs that aim to improve the enabling environment for private sector activity.[6]
- Equally, outcomes-based funding could be structured as part of a capital stack for a specific investment.

Questions for discussion

- Development Impact Bonds (DIBs) are one type of outcomes-based funding instrument. One drawback is that they are typically contracted as projects, and can be seen as a form of 'social structured finance'. However, in the sanitation space, we may be looking to support multiple sanitation enterprises, where the social impact of these enterprises can be compared (and incentivised) against a common yardstick of outcomes metrics. This implies moving away from a single investment for a single intervention via a one-off contract, to a broader and open-ended 'outcomes fund'. How would this work in the sanitation sector?

- Some sanitation enterprises will deploy significant capex and hence have significant working capital needs. Outcomes-based funding may not be best-suited to these capital-intensive

[4] Outcomes payments could be structured to flow either to the sanitation enterprise itself, or to its investors (or some combination). In the former, there would be a direct and immediate benefit to the enterprise's bottom line. For enterprise-focused social investors, participating in a DIB structure, would generate a cash 'top-up' on top of the potential returns from the underlying debt/equity investment.

[5] Put another way, it's an aid delivery mechanism that does not require a private enterprise to become a contractor to a donor).

[6] For example, grant-funded technical assistance to upgrade the regulatory rule-book and improve the investment climate, or support to enhance the capacity of senior staff at regulators.

enterprises. In practice, how could outcomes-based funding be incorporated as part of a broader capital stack, or open-ended investment fund structure?

Appendix: The Relevance of Development Impact Bonds to Sanitation

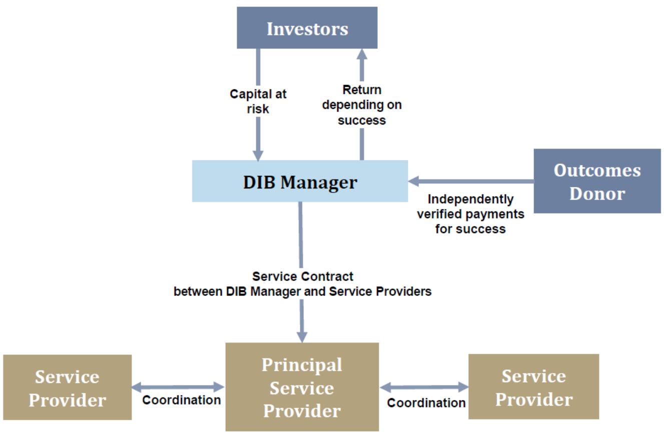
There is a clear need to identify, evidence and implement effective sanitation interventions to improve value-for-money of existing funding and 'crowd in' innovative private sector service delivery. This requires:

- Partnering with local organisations to design products/services that are appropriate to the local context – and empowering and incentivising service providers to deliver them;
- Meaningful participation from in-country (including government) stakeholders from the outset to garner their continued support and engagement after the donor funding ends;
- Regular, real-time reporting on results to allow the program to be adapted as needed during implementation, rather than an ex-post evaluation; and
- A systematic approach to monitoring and evaluation, focusing on (i) health and other outcomes, rather than inputs; (ii) sustained impact, rather than short-term results; and (iii) value-for-money, both compared to a minimum threshold and to other approaches.

These necessary characteristics are all key elements of Development Impact Bonds (DIBs), a form of Results-Based Financing that is particularly applicable to WASH given the need for behaviour change at the user level to achieved sustained impact and focus on performance evaluation and assessment[7].

Development Impact Bonds

A DIB brings together investors and outcomes donors to finance a program that aims to achieve independently verified outcomes. The key actors are:



- The ***Outcomes Funder*** pays investors if – and only if – the program achieves pre-agreed outputs and outcomes. The Outcomes Funder and host government (if different) set the guidelines that the program has to adhere to, but are not involved in delivery. The Outcomes Funder is regularly informed of progress by the DIB Manager.
- ***Investors:*** fund the program costs, except independent verification. Their financial returns are derived solely from the achievement of pre-agreed and fixed value outcomes, creating a strong incentive to performance manage the program and its costs. Their financial commitment is also an attractive risk mitigant for donors, who can rely on their financial standing (stronger than many smaller service providers) and commitment to due diligence and contract management.
- The DIB Manager oversees the program and liaises with Investors. They analyze service delivery and output/outcome data continuously, and guide the work of the Service Providers accordingly.
- Service Providers: one or more operating entities deliver the intervention(s).

Sources of differentiation

In a DIB, investors pay in advance for interventions to achieve agreed results, and work (through a DIB Manager) with delivery organizations to ensure that the results are achieved efficiently and effectively. Donor funding guarantees payments to investors if, but only if, the interventions succeed in achieving independently assessed results. Returns to investors are linked to the extent to which agreed results

[7] UN Information Brief (2015) *Implementing Water, Sanitation and Hygiene*

are achieved. In this sense DIBs are like traditional results-based lending, except with the addition of up-front external working capital to ensure finance at affordable rates for service providers.

But DIBs differ more fundamentally from traditional results-focused lending in that the external investors' focus on maximizing their return incentivizes continuous improvement not just in implementation methods, but also in the underlying structure of the program. So, for example in a multi-component program, the balance between the components can be continuously adjusted depending on what the data shows about their relative success, rather than just the more typical results-based focus on improvements in detailed implementation of pre-defined components. This ensures a focus on flexible program implementation, rather than a more bureaucratic focus on implementing pre-defined inputs.

In summary, a DIB offers several potential benefits for sanitation programs:

- The DIB Manager works with the service providers – normally closest to the end users – to identify the best way to achieve the target outcomes, and only pay if this is successful;
- Ongoing assessment and modification of the delivery model limits the risk of funds being deployed towards ineffectual programs and creates a valuable body of learning;
- It ensures a collaboration – and alignment of interests – between service providers, investors and donors that can have ongoing benefits; and
- It creates the opportunity for future programs to be increasingly funded by domestic donors, government, private sector and households, reducing the dependency on aid.
- The focus on outcomes potentially makes it clearer for outcomes funders (whether donor agencies or, at a later date, in-country governments) which department(s) are best placed to commit resources to programs.