

Luc Rigouzzo

Enabling the maximum number of people to access essential services will not be possible without private sector involvement and appropriate pricing of the services concerned

Warning

The contents of this site is subject to the French law on intellectual property and is the exclusive property of the publisher.

The works on this site can be accessed and reproduced on paper or digital media, provided that they are strictly used for personal, scientific or educational purposes excluding any commercial exploitation. Reproduction must necessarily mention the editor, the journal name, the author and the document reference.

Any other reproduction is strictly forbidden without permission of the publisher, except in cases provided by legislation in force in France.

revues.org

Revues.org is a platform for journals in the humanites and social sciences run by the CLEO, Centre for open electronic publishing (CNRS, EHESS, UP, UAPV).

Electronic reference

Luc Rigouzzo, « Enabling the maximum number of people to access essential services will not be possible without private sector involvement and appropriate pricing of the services concerned », *Field Actions Science Reports* [Online], Special Issue 4 | 2012, Online since 25 June 2012, Connection on 10 October 2012. URL : <http://factsreports.revues.org/1565>

Publisher: Institut Veolia Environnement
<http://factsreports.revues.org>
<http://www.revues.org>

Document available online on: <http://factsreports.revues.org/1565>

This document is a facsimile of the print edition.

Creative Commons Attribution 3.0 License

E- Enabling the maximum number of people to access essential services will not be possible without private sector involvement and appropriate pricing of the services concerned

Luc Rigouzzo

Executive President of Amethis Finance and former CEO of Proparco

Abstract. Private sector provision of basic services (water, energy, financial services and housing) for people in developing countries is a necessity if we really want to try to curb poverty. However, ‘traditional’ private funding is not spontaneously directed towards these sectors, largely as a result of rejecting the idea that poor population groups should ‘pay’ for essential services; an issue that has often been the subject of opposition campaigns mounted by social stakeholders. Nevertheless, there are many, many examples to show that given the impact of these services on their quality of life, consumers in these countries—and especially those at the ‘bottom of the pyramid’—are prepared to pay for them as long as they have access to a high-quality service. In these sectors, the nominal cost of the service concerned matters much less than its opportunity cost and the impact it will have on the lives of those who benefit from it. Very often, this service may even be paid for in advance as a way of enabling families to gain greater control over the expenditure they can devote to obtaining it.

It is, however, important to distinguish between the supply of essential services and those of consumer goods, and—of course—to avoid abuses. In any event, the possibility of building financially-balanced models is what governs the process of securing sufficient funding from local and international financial institutions. In this area, as in others, the way forward is probably the happy medium: avoiding the excesses of overpricing, but accepting the need to maintain profitable economic models. These should enable investors to receive a level of profit that encourages them to continue and increase their investment, thereby increasing the number of recipients as quickly as possible. Aspiring to build social models that reject the ambition to achieve a reasonable profit and rule out any distribution of dividends to shareholders is to condemn the poorest populations to long-term dependency on charity or hypothetical budget surpluses, and seriously restrict their access to essential services.

Keywords. Essential services, pricing, bottom of the pyramid, water, energy, microfinance, PPP, public-private partnerships, cost of risk, risk rating.

Private sector provision of basic services (water, energy, financial services and housing) for people in the countries of the South is a necessity if we really want to try to curb poverty, because neither external funding (development aid) nor internal funding (national budgets) are sufficient to meet the needs of these population groups as defined in the Millennium Development Goals. In illustrating its points, this article will draw on the experience of Sub-Saharan Africa, because this is the continent that faces the greatest challenges: less than one person in six has running water in their home, and more than 40% have no access to a treated water delivery point. In many countries, more than 8 people out of 10 have no access to electricity or banking services. Against a background of accelerating urbanization, the inability to provide access to social housing poses the risk that the majority of the

continent’s major cities (Sub-Saharan Africa has more cities with populations over 1 million than Europe) will be surrounded by enormous shantytowns and all the conflictual overtones of such development.

1 The needs of the poorest population groups cannot be funded solely from public sources

The international community is addressing the Millennium Goals by focusing its actions and resources on a series of measurable targets to be achieved by 2015 (e.g. to reduce by half the proportion of people with no access to safe drinking water). Nevertheless, public development aid—generous though it is—will not be sufficient to provide the resources required to achieve these ambitious goals. For example, the

annual investment in water supply and wastewater treatment required to achieve the Millennium Goals will be approximately \$80 billion, compared with the \$100 billion of development aid available globally to address every issue.

The following graph, applicable only to the African continent, illustrates the gap between the need for investment and the current level of public funding commitment for key services:

As in all other economies, it is therefore important that these services, which can be profitable, are supplied by the private sector within—of course—a regulated framework designed to protect the rights of recipients.

2 However, 'traditional' private funding is not spontaneously directed towards the consumer goods and essential services sectors

- overestimation by many investors of the risks posed by investing in these countries
- the judgment that the political risks are too high, or that in any event governments have a propensity to involve themselves (often on a discretionary basis) in these sectors that are—quite rightly—seen as politically sensitive (sudden and dramatic changes in pricing policy, changes to regulatory frameworks without consultation, etc.)
- the difficulty in accepting that poor population groups should 'pay' for essential services; an issue that has often been the subject of opposition campaigns mounted by social stakeholders

2.1 The first of these stumbling blocks remains a real constraint and, as the following graph shows, there persists a considerable gap between perception of the risk posed by African countries and the reality.

The fact is that the majority of non-investment grade¹ countries in the world today are in Africa. Those bank practices that nearly always rate private risk lower than country risk are not appropriate for these regions of the world, where the best private counterparties may present a better risk than the states in which they are domiciled. But when we look at the available data, we can see that doubtful debt rates for larger SMEs in Africa are roughly equivalent to those in other emerging countries (6.8%, compared with 5.1%). These data are confirmed by the low rates of loss reported by the majority of development funding institutions that focus on the private sector (SFI, DEG, FMO, Proparco, etc.).

¹ Investment grades refer to the bonds issued by lenders, which are rated by ratings agencies on a scale from AAA to BBB—(Standard & Poor's scale). These differ from those described as 'non-investment grade' (also referred to as 'speculative grade' or 'high yield'), which are much more risky, but promise a more substantial return (ratings from BB+ to D on the Standard & Poor's scale). Investment grade bonds present a low level of risk and are the only bonds that institutional investors may purchase, since the other grades are considered as excessively risky. (ed.)

In fact, as the graph above shows, there is a considerable market gap between the data published by ratings agencies and the reality of the situation. So for a 'Single B' country like Ghana, the ratings agencies estimate that an 8-year loan could result in 30% final losses, whilst the data from financial institutions indicate a rate of below 5%. In this instance, the result is a gap of 1:6 between the actual risk and the perceived risk.

2.2 On the other hand, after a decade of mixed results from Public-Private Partnerships (PPP), the stumbling block caused by the perception of high political risk is gradually disappearing

The majority of those involved agree on the urgent need to promote effective partnerships between public and private stakeholders; partnerships that simultaneously address the extent of investment needs, improve project management and stimulate long-term local savings.

Public-Private Partnerships (PPP) can enable improvement in the management of public services and the contribution of private capital to public interest projects; they also encourage the production of basic services at a cost that makes them accessible to the greatest number of people. The responsibility of the public component is then to guarantee that the general interest is met and upheld by focusing on the functions of providing impetus, prescription and control, because in the end, it is the people themselves who must benefit from the new services offered. The role of development funding institutions should, on the other hand, concentrate on leveraging private resources by using the full range of financial tools available in order to enable the emergence of long-term PPPs, i.e. partnerships that are economically effective, financially profitable and socially and environmentally equitable.

Having been powerfully imposed on industrial societies, PPPs are now becoming increasingly prevalent in emerging and developing countries. It is however correct that the recent history of PPPs has also been peppered by failures that have attracted a great deal of media coverage and have tended to conceal the increasing number of successes. Many PPP failures have also resulted from the third stumbling block and central focus of this article: the refusal to accept that the poorest populations should pay a 'fair price' for an essential service is precisely what prevents the introduction of properly balanced contracts between the public sector and private operators. As a result, these private operators focus on the 'richest' consumer segments (private companies, urban middle classes, etc.) and do not seek to serve the majority of people in these countries, regardless of the fact that they represent a class of solvent consumers.

2.3 There are many, many examples to demonstrate that the third stumbling block (requiring consumers to pay for essential services) is not justified, and that the private sector can be an effective provider of services to the poorest populations.

On the other hand, given the impact of these services on their quality of life, consumers in these countries are prepared to pay for them as long as they have access to a high-quality service.

Microfinance, the water industry and mobile telephony are all good examples of this.

2.3.1 Microfinance

The microfinance industry was the first to illustrate this paradox. It has rightly been considered as a driver of social progress over the last 20 years, because it provides access to credit and secure savings for population groups with no access to banking services. As a result, hundreds of millions of people now benefit from these services, which have undeniably helped them to stabilize their income and contributed to helping them out of poverty. Nevertheless, this has been achieved at a 'price'—that is to say a 'cost'—that could have been seen as prohibitive, since the majority of institutions charge annual interest rates that fluctuate between 25% and 40%; rates substantially above those offered to urban dwellers with bank accounts in these same countries.

Sadly, this growth in microfinance has not prevented banking penetration on the African continent from remaining at a very low rate even today, as the following graph illustrates. The banks have not taken the microfinance route and have not targeted this category of the population for a number of reasons, whether regulatory (caps on interest rates), image-related (no institution wants to be described as a usurer) or a lack of understanding of this category of consumer.

2.3.2 PPPs in the water industry

Despite its long-term profitability, the water industry has paradoxically been one of those achieving the greatest number of successes. This is particularly true in the case of Africa, where the number of privately-managed water supply points has grown significantly, providing access to water for more than 100 million people and substantially reducing water losses (in most cases). Nevertheless, in many cases, the price of water in rural areas is substantially higher than that charged in major cities. We also observe that PPPs are often partnerships built with local midsize companies, and that international corporate groups no longer have the monopoly.

Lastly, the trend in the types of service provided (production, distribution, etc.) is towards diversification.

PPPs are clearly not a universal panacea, but the example of the water industry does show that where political and social realities are properly addressed and a stable regulatory framework is in place, private investment can play a crucial role in providing the poorest populations with access to water, and more generally, to all essential services.

2.3.3 Although it is probably a less 'essential' sector, mobile telephony also provides an illustration of this problem

In most countries of the South, the growth in mobile telephony—encouraged and regulated by public authorities—is being driven by the private sector. The rapid introduction of mobile telephony in a very large number of developing countries is quite remarkable: for example, Africa has seen annual growth of above 40% in subscriber numbers over the past

four years. Achieved in a context where the proportion of income available to pay for these new services seems inevitably limited, this success demonstrates the relevance of the model adopted, and in a wider sense, the dynamic nature of the African internal market.

Nevertheless, this growth (as with microfinance) has not been without its negative effects, and the proportion of household budgets now being spent on mobile phone charges (without a corresponding increase in income over the same period) is an area of concern. At the same time, some of the poorest population groups—especially those in rural areas—are persistently excluded from network access.

So many challenges remain. From the operator and user points of view, population coverage must be improved and service access costs reduced, and this reduction can already be seen in the majority of countries.

3 Some lessons and general rules regarding the pricing of services for the poorest populations

3.1 The first lesson to be learned from microfinance is that where essential services are concerned, the 'price' of the service matters less than its 'opportunity cost'

In this sector, the nominal cost of the service (the interest rate in the example of microfinance) matters much less than its opportunity cost and the return that the investment will generate for the lender or recipient of the service. As a result, there is no doubt that borrowing at an APR of 40% could be seen as extremely prohibitive for a peasant in the Sahel, but not if the loan enables him to develop a business whose return on investment is 5 to 10 times higher (which could be the case with livestock farming, small retail shops or craft production, for example). It becomes clear fairly quickly that this access to finance could enable the borrower to emerge from dependency relatively quickly and enable him to create and stabilize an income. Clearly, this should not be used to justify all abuses of the system. Everything therefore depends on the ability to provide a high-quality service, and in the case of microfinance, to provide borrowers with the support needed to ensure that their investments are compatible with loan charges. Unfortunately, there are many examples of such arrangements getting out of control around the world. For example, in South Africa, the cost of microfinance is all the more prohibitive because it has long been used as a means of funding direct consumer spending (on TVs, etc.) or—unfortunately—non-profitable investment (e.g. to meet funeral expenses).

But it is important that we do not fall into the trap of failing to see the wood for the trees, because the majority of the world's microfinance institutions have made it possible for their borrowers to improve their lives and gain access to profitable work.

In the case of microfinance, the high interest rate is due essentially not to high levels of bad debt—which is actually very low in microfinance and often as low as 1% to 2%—but quite simply to the cost involved in distributing large numbers of loans each of very small size in areas of low customer density. In microfinance, it would be fair to assume that in outer

urban suburbs and rural areas, the majority of the interest rate charge (around 25%) is required simply to cover the cost of distributing small loans. The high cost of distributing products and services to the poorest population groups holds true for most industries. We see the same type of cost structure in the water industry and in consumer retailing. One of the great challenges in supplying services to the poorest populations is the ability gradually to reduce this distribution cost by increasing the number of recipients as a route to achieving economies of scale.

Happily, this increase in volume can be achieved fairly quickly, because when services are delivered professionally, we see extremely rapid growth rates in these sectors. It is not unusual to see microfinance customer numbers grow by more than 50% year-on-year. The same is true of other ‘bottom of the pyramid’ sectors when the service concerned delivers a real benefit to consumers. This in turn enables rates, costs and prices to be reduced consistently, made possible by economies of scale, and at a later stage by the emergence of competition.

Nevertheless, this should not justify all abuses of the system, and there are ways of verifying price ‘fairness’, although ultimately it will also be regulated by the market itself.

3.2 Once again, the service may be paid for in advance where it can be shown to significantly improve living conditions and be of high quality.

In the context of microfinance, this advance payment was evidenced in the first generations of these institutions by the fact that borrowers had first to accumulate a minimum level of savings in order to qualify for a loan. ‘Deposits made loans’. In the water and energy sectors, South Africa—a powerful laboratory for testing models for the supply of services to the poorest populations—has clearly demonstrated, with the example of energy supplies in Khayelitsha township near Cape Town and water supplies in Soweto, that populations themselves may request the ability to access the service on the basis of advance payment. This solution allowed families to keep better control of the expenditure they were willing to devote to this service.

The project to supply drinking water to the township of Soweto is an extremely interesting one from this point of view. The project was launched by the city of Johannesburg some years ago on the basis that this township with a population in excess of 2 million contained communities unable to continue paying for water, and was served by distribution networks in very poor condition with absolutely colossal levels of leakage and consumption that resulted in serious environmental consequences, especially in terms of wastewater, which was being discharged untreated in large quantities by the township.

The city authority therefore entered into an agreement with the communities concerned under which it would write off their debts and draw a line under past arrears in return for repairing and upgrading the supply network, and installing 162,000 prepayment water meters. The agreement enabled all households to have their water installations upgraded in return for payment in advance for the service, which in turn enabled the individuals concerned to control their expenditure, as discussed above.

In addition to improving the quality of service for the communities involved in terms both of water quality and quantity, the beneficial effects of the project also included a massive reduction in water consumption, and therefore in the level of liquid effluent discharged from Soweto, thus delivering a significant reduction in the township’s environmental footprint. It is probable that negotiation of this win-win contract was considerably facilitated politically, because the authority itself negotiated directly with the communities. It is likely that this would have been more difficult in the context of a public-private partnership contract involving national government.

In any event, the example of Soweto demonstrates once again that when consulted, the poorest populations make it clear that what they want is access to a high-quality service and they are prepared to pay for it. It also demonstrates that a local authority can be more politically courageous than a national government in managing this type of issue for the simple reason that it has direct contact with the communities concerned, and is therefore better at identifying their needs and political negotiation capabilities. There are many such examples, which also highlight the fact that local authorities are often better partners than national governments when it comes to building effective public-private partnerships, since regulation requires direct feedback from the communities concerned.

4 The ability to build financially-balanced models is essential

Financial continuity is the determining factor governing the long-term funding of investment by local and international financial institutions. When referring to investors, we are not talking only of international investors. It is striking to note, especially in Africa, that even local investors often overestimate the risk and without additional guarantees are often ultimately reluctant to take it on, even where high-quality institutions are involved (‘A Prophet Hath No Honor in His Own Country’).

Of the projects I have been involved in funding over recent years, two have left particularly strong impressions. The first was in Kenya in 2003, when for the first time, the French Development Agency underwrote a bond issue by Faulu, a Kenyan institution offering microfinance for women. The 5-year bond issue was valued at 500 million Kenyan Shillings—equivalent to around €5 million—and was the first to give an African microfinance institution access to the market (the Nairobi stock exchange in this case). A quarter of the risk was taken by investors, with the remaining three quarters underwritten by the French Development Agency.

The deal resulted in micro-loans being advanced to 24,000 women. At the time of the issue, Faulu was already a relatively mature microfinance institution with a very high profile in Kenya. As such, an issue of this type in another market would not have required external guarantees. It would have required only a straightforward direct market issue by Faulu or a loan from a local bank. But this first deal required a guarantee underwritten by an external backer. Such a guarantee was only given because Faulu had in place a balanced financial model and could demonstrate its ability to repay.

It is interesting to note that since this first deal, Faulu has made further bond issues via the Nairobi market with no external guarantee, and that the market now recognizes that this institution is capable of direct borrowing on its own account. Once again, this is possible only because it is financially well-balanced.

The second example is that of Eduloan in South Africa. This microfinance institution provides loans to enable black students to attend South African universities, most of which are privately run. Eduloan entered into an agreement with these universities under the terms of which it advances loans to students at relatively low rates of interest to cover the cost of their university entrance and education. Once again, the first time that this institution wanted to borrow extensively from a local bank, it was not able to do so without a guarantee underwritten by an external backer, since local banks saw the proposition as high risk, quite simply because they had very little knowledge of either the sector or the institution.

It is also instructive to note that the learning curve was extremely steep, since the bank that had agreed to lend against a guarantee provided by an external backer decided only two years later to take a direct stake in Eduloan, demonstrating that by this time it was fully aware not only that the proposition was a good risk, but also that as an institution it had the potential to deliver a sufficient return on capital to be attractive to a private bank.

It is thanks to this type of transaction that Eduloan has been able to provide hundreds of thousands of South African students with access to further education. Once again, this would not have been possible without the commitment of local capital, and that commitment could not have been obtained without appropriate pricing.

Lastly, this same type of reasoning also applies to much larger investments, and I can think of a third example involving energy supplies in Uganda. In Uganda, 90% of the population has no access to electricity. On average, Ugandans use 200 times less energy than Europeans. What's more, the electricity that is available is relatively expensive, because the current alternatives are essentially thermal power, given that the existing plants have reached saturation point. The Bujagali project aims to double power generation in Uganda by means of a run-of-river hydro dam. The project represents a very high level of investment at around \$700 million to \$800 million, but since the energy generated will be hydroelectric power, its cost will be very competitive. It will double the country's power-generating capacity, and therefore provide hundreds of thousands of people with electricity, at the same time as reducing the cost of energy by using a cleaner and greener method of generation, because hydroelectric plants make a positive contribution to containing climate change. A concession contract was signed between the Ugandan government and the Aga Khan Group, enabling this private equity investor to become involved with the support of backers.

In this example, the private operator, the investor, should ultimately receive a comfortable return on its capital, and in any event, one that justifies the risk accepted in making the investment. That said, once again the end-consumer should eventually benefit from substantially cheaper energy costs in Uganda, making this a win-win arrangement. But this model

could not exist, the \$800 million could not have been raised and energy prices could not have been lowered for consumers without a context in which the ultimate recipient pays for the electricity. Naturally, this payment does not necessarily involve uniform and/or unfair payments. As in the water industry, the energy industry may also make use of social pricing structures with payment levels differentiated on the basis of consumer categories, under which large companies and government institutions pay more than private individuals and very small consumers, because the operator has negotiated an average tariff that enables these different categories of customer to be aligned and balanced in certain ways.

5 It is, however, important to distinguish between the supply of essential services and that of consumer goods, and—of course—to avoid abuses

This argument in favor of the need to price essential services in such a way as to enable access to them by the maximum number of people does not apply strictly in the same way to consumer goods, and the entire 'bottom of the pyramid' debate of recent years has sometimes mixed up and confused essential services with consumer goods.

This is not to say that there is no justification for trying to price a pot of yoghurt, a pair of glasses or a light bulb correctly, but it is one of the most archetypal market conundrums within which a manufacturer faces three challenges in terms of consumer goods: (i) adapting its products to meet the needs of specific consumer groups (in this case, the poor), (ii) enabling customer access by adapting its distribution network, and (iii) adapting its prices (affordability).

The issue of arriving at a fair price for consumer goods must certainly address the same concern as essential services, which is to absorb the additional distribution costs involved in distributing small and limited unit quantities to the maximum number of customers. Cost of distribution therefore remains the paradigm and principal challenge common to essential services and consumer goods.

But essential services deliver a much higher return on investment for the poorest populations. Access to high-quality drinking water simultaneously reduces the frequency of illness, enables improved human development, and is therefore an extremely profitable service for the recipient. As we have seen, where access to a financial service enables investment and—thereby—to gainful employment, this too is extremely profitable. All the research suggests that the same is true of energy, but less true for some consumer goods, which deliver fewer and less important benefits.

It is therefore important to make a distinction between these two broad categories (essential services versus consumer goods), and—paradoxically—it may be justified to require rural consumers to pay more for essential services, for example, than urban consumers, given the importance of these services for the wellbeing of the communities concerned and their ability to self-regulate their consumption of services.

6 Conclusion

Aspiring to build social models that reject the ambition to achieve a reasonable profit and rule out any distribution of dividends to shareholders is to condemn the poorest populations to long-term dependency on charity and seriously restrict their access to essential services.

It is quite paradoxical to find that the microfinance industry, which was one of the first to demonstrate the justification behind charging for services to poor population groups, is now lobbying in favor of ruling out any distribution of dividends by social businesses.

As generous and understandable as this approach is, we must unfortunately accept the fear that this ‘well-meaning’ viewpoint will once again reduce future investment in these services, and will ensure that entire categories of the population remain without access to them and continue to live in the very conditions of poverty that those who defend social business wish to avoid. In this area, as in others, the way forward is probably the happy medium: avoiding the excesses of overpricing and excessive profits, but accepting—from our point of view—the need to maintain business models that are profitable business models. These should enable investors in these sectors to receive a level of profit that encourages them to continue and increase their investment, thereby increasing the number of recipients as quickly as possible. Making the opposite choice can lead only to a Malthusian mindset, which, by ruling out the distribution of dividends and removing profit, will result in limiting investment and—ultimately—in limiting the rate at which the poorest populations can extricate themselves from isolation and poverty.