# Generic Terms of Reference Financial Sustainability Analysis of WSS Investment Projects and Their Entities

Objective

The *conceptual assessment* both at the diagnostic level as well as the future planning level described is intended to minimize the need for resources, while at the same time provide a good approximation of the feasibility of a given option. It is intended to review several alternative options to arrive at the preferred one. Also, the diagnostic review can be curtailed if there is still uncertainty on whether the client demand is confirmed.

The assessment of a potential investment program for any given WSP requires two main components: (i) a diagnostic assessment of the current situation which is often broken down into numerous sub-components; and; (ii) the development and assessment of a coherent plan going forward, often intended to address the main strategic objectives or corrective actions that have been identified during the diagnostic review. The process is generic, but the outcomes can differ significantly from one case to another, depending on the priorities which are selected and the available resources.

The TORs presented here are for a conceptual feasibility assessment that requires the expertise of primarily *two highly skilled specialists* focusing the technical and financial aspects of the various tasks: (i) to carry out a diagnostic assessment of the WSS provider; and (ii) to develop a conceptual financial and implementation plan to address major strategic objectives. The assistance of local consultants may be needed to help in data collection and interpretation during the analysis. The two individual specialists must work effectively with the WSP management and staff, with each other as well as with policy makers since ultimately, all parties are convinced that the option chosen is undeniably the desired course of action and that it can be successfully implemented.

Scope of Work

*Task 1: Carry out diagnostic assessment on the technical, commercial, and financial management operations of the WSS entity and sector policy and governance framework (See for detailed components for diagnosis of WSP)*

A thorough diagnostic is the essential first step in understanding the specific issues facing a utility and forming the basis on which to develop a program of institutional strengthening, expansion, or diversification. Generally, technical, policy and governance deficiencies are closely linked to financial outcomes, so it is important for the analyst to identify these relationships in coming out with their overall assessment. This can be achieved by either tracing the impact of the technical deficiency to the financial outcome, or by tracing the financial deficiency back to the technical operation.

*Task 2: Develop coherent management strategy and actionable items.*

A coherent strategy is one that has considered all aspects of the operations, not just the technical issues. It is also one that is based on realistic expectations including the expectations on financing. Nonetheless, the WSP may have developed certain priorities for capital expenditure that have not been met due to shortage of funding. This task is intended to drive the forward planning process. However, it is important to indicate that a diagnostic is not complete without a discussion with the management and staff on where they wish to go in terms of the organization and its operations, and how they believe this will get them to their goals. Such a discussion can shed light on whether management is coordinated with the condition of their enterprise and whether their plans are realistic.

The strategic plan provides the following inputs to the utility's planning cycle:

1. Overall WSS service objectives;
2. Focus and priorities such as expansion of the network or improvements in performance for which future capital expenditures should be directed;
3. General investment requirements for meeting specified service objectives;
4. Objectives for modernizing diversifying and other improvements in networks, facilities, equipment, systems, process, and procedures;
5. Priorities for replacing fully depreciated assets and for unforeseen contingencies; and
6. A realistic assessment of the value added of non-core businesses and priorities for the disposal/divestiture of such businesses.

*Task 3: Develop investment budget envelope*

Generally, the senior management is responsible for putting together the strategy with the help of a planning unit. In formulating the strategy, management should have developed a good assessment of the financing constraints and opportunities, as it is fruitless to direct the operational units to develop projects that ultimately cannot be implemented because of lack of funding. Alternatively, a long-term strategy could be segmented in discreet financeable stages and taken up piecemeal. Again, if the management intends to develop a bankable project or program, the importance is to deal with realistic expectations. Management should develop a funding envelope in consultations with its owners, potential lenders, and government oversight agencies.

*Task 4: Develop a dynamic financial model for assessing and validating financial sustainability of technical options*

The operations of WSPs involve a dynamic system with many variables linked to each other and that many operational variables affect financial outcomes. As such, operational and commercial units must work together and effectively communicate in putting actionable proposals forward. The finance or planning unit must support these units and must be able to clearly demonstrate the more desirable alternatives. Ultimately it must be able to show the utility's capacity to assume debt financing and to repay it effectively. A coherent plan requires an "organizational approach" to planning, not one unit dictating the technical requirements as it often the case among utilities in the developing world.

One excellent way to ensure the adoption of an "organizational approach" to planning and to create added credibility of the plan is for the utility to have a well-developed financial planning model that effectively links all key technical and operational variables with financial ones and presents them in the three main financial statements. The financial model also facilitates an understanding of whether the utility would be able to cover its debt service in future years, thus providing needed information to lenders. To this end the financial specialist will first need to develop a fully interactive financial projection model that can simulate financial solutions under varying investment and operating costs, tariffs, and volumetric demand scenarios.

*Task 5: Populate financial model with current consolidated operating and financial information of the WSP*

This task involves developing a base financial projection of the WSP consolidated operation utilizing current operating and financial paraments. This means, projecting forward existing and already programmed plans and parameters including, but not limited to: (i) approved connection programs; (ii) investment projects already started which will continue; (iii) projections of current debt obligations that require servicing; (iv) current operating financial parameters; and (vi) other information that would fully capture the current financial situation of the WSP, projected forward. The output would come up with a base case projection of financial outcomes without the actionable items being contemplated. These should be closely reviewed with the management of the WSP for accuracy. More importantly these base case projections may alert to a possible future problem which may require corrective action through a revision of the strategic plan.

*Task 6: Develop technical options for accomplishing strategic objectives*

The consultants should work with management to identify different technical options for achieving the strategic objectives. These options could be different sets of actionable items or just different phasing of the items. The consultants will then develop and finalize the investment component and implementation plan along with technical parameters for each option. The estimate of preliminary investments costs should be broken down for each year of implementation. The planning horizon for setting investment and operating assumptions should be no longer than five years. Three-year horizon for assumptions would be preferable if funding is limited. The financial projections of those planning assumptions should extend from 20 to 25 years.

In addition, estimates of operating and maintenance expenses should be developed based on volumetric consumption, to derive the total anticipated costs at given production levels. Again, operating assumptions should extend to 5-years maximum. The important point in this task will be for the consultants to develop cost-benefit relationships with each actionable item of the strategic plan. For example, if the actionable item will be to reduce technical losses by say, 2% each year for five years.

*Task 7: Develop financial projection for each technical option and derive a financial solution by engineering a blended finance strategy*.

The financial consultant will incorporate investment and O&M cost data and derive projected per unit costs for actionable items. The consultant will also need to develop feasible financing assumptions which would be incorporated into the financial projection model. The financial consultant will financially engineer a financing structure including a mix of loans and grants that will render a financial solution. Such a solution is defined as a positive cash flow in each year of the projected period while at the same time achieving acceptable rations for debt service, profitability, and liquidity. In formulating these financing options, the consultants will need to analyze the various risk issues and recommend options for de-risking such risks.

Another sub-task under this activity deals with developing the framework for setting and adjusting tariffs over the projected period. This would-be part of an overall regulatory framework that would be needed to implement this project. The tariff setting exercise must start off with overall policy objectives of the government as well as the legal framework that will eventually reach cost recovery levels. In this regard, the consultant will hold discussions with the relevant government officials to sort out the frameworks and timeline for achieving such goals.

*Task 8: Finalizing preferred option and confirming financing plan performance targets*

The final step will be to agree on the preferred option and this must be done by the management going through all main assumptions and confirming to their achievement. This task is not about setting covenants but making sure that the WSP management considers the plan achievable. This is particularly important if commercial lenders are also involved.

Deliverables

1. Diagnostic Report
2. Assessment Matrix
3. Strategic Plan
4. Summary of Technical Options
5. Base Financial Projection of WSP
6. Financial Projections of Technical Options
7. Recommended Option with Confirmed Financing Structure
8. Annex of Financial Projection Assumption