Chapter 5

Working in Partnership with the Private Sector
3.5. WORKING IN PARTNERSHIP WITH THE PRIVATE SECTOR

Basic reforms

Responsibility for water and sanitation services may rest at municipal, regional, or central government level. Many countries have recently undergone water sector reform, and it has become more common to separate the water provider institutionally from other arms of government by setting up "parastatals" or state-owned enterprises. By introducing some degree of institutional independence and financial incentive, considerable improvements in service efficiency have been made (Johnstone and Wood, 2001). Many have engaged the private sector in water services provision, utilising various institutional approaches from fully public water management to fully private (Figure 5.1). While discussions about private sector participation in the water sector often concentrate on full divestiture, which includes the transfer of asset ownership and responsibility for its management, there are in fact many other forms. A common point of all of these options is that the government always retains responsibility for setting and enforcing performance standards - regardless of the form of private involvement chosen.

Figure 5.1. Basic modes of water sector organisation

Source: Blekland (2000).

Australia
Austria
Belgium
Canada
Czech Republic
Denmark
Finland
France
Germany
Greece
Hungary
Iceland
Ireland
Italy
Japan
Korea
Luxembourg
Mexico
Netherlands
New Zealand
Norway
Poland
Portugal
Spain
Sweden
Switzerland
Turkey
United Kingdom
(England and
United States)
Note:
1. "Both" means private and public management
Source: Adelg
### Table 5.1. Institutional arrangements in OECD countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Public Supply</th>
<th>Ownership¹</th>
<th>Management</th>
<th>Economic Regulator</th>
<th>Environmental Regulator</th>
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<td>Both</td>
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<td>Norway</td>
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<td>Both</td>
<td>Municipal</td>
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<td>Both</td>
<td>Both</td>
<td>Independent</td>
<td>Independent</td>
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¹ n.a. not available.
² “Both” means public and private ownership structures co-exist.
³ Private management exists but is marginal.

Source: Adapted from OECD (1999).

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Private management

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of assets may otherwise always standards —
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OECD countries have generally been moving away from the "fully public" model for the water sector in recent years. The government role in water management has also been shifting from that of primary service provider to one of establishing and regulating an operating environment in which communities, the private sector, and NGOs become more active in the process of providing water and sanitation services. In several countries, independent economic regulators have been set up to regulate water prices autonomously. These regulators usually set prices and may have other responsibilities such as establishing service performance standards. Table 5.1 summarises the current situation.

Water supply systems remain largely publicly owned, mainly because of their natural monopoly characteristics. Yet service management is increasingly being delegated to private operators. This approach seems particularly well suited to decentralised systems where municipalities see delegation as a way to overcome their own lack of technical expertise or financial resources. In several countries, service providers can decide whether they want to manage the service themselves (direct management) or to delegate responsibility to a private operator via concessions (OECD, 1999b).

It is recognised that water service provision can be inefficient when too many independent providers are involved. Hence, there is a growing tendency in OECD countries for water systems to be managed by groupings of municipalities so as to organise supply at a larger scale. Other forms of consolidation have also been occurring: the Netherlands, for example, reduced the number of water boards from 210 in 1950 to 15 in 2002 (van Dijk and Schwartz, 2002). The degree of management autonomy of local water utilities also seems to be increasing (OECD, 1999b).

Many cities, particularly in the developing world, urgently need comprehensive reform of policies and institutions to stop water infrastructure deterioration, promote efficient and sustainable water use, and generate revenue for needed investments. These reforms will inevitably require increased cost recovery, improved resource conservation, and more pollution prevention at the source.

Private sector participation

Since the mid-1990s, an important approach that has been gradually introduced in the water sector is the notion of partnerships between public and private agents. While the 1990s saw a significant increase in private sector participation in the water sector worldwide (Figure 5.2), it is still estimated that less than 10% of the world's population is provided with drinking water through private operators (Blokland, 2000). According to the World Bank, private sector participation is most common in Latin America, followed by
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Figure 5.2. Number of projects with private participation (1990-2000)


East Asia, Central Asia, and Eastern Europe. While the nature of private sector participation may range from partial financing of investments to an increasing role in the operation of services, most countries have opted for the concession approach, in which the private sector participates in managing some services but the public sector retains ownership of the system.

It is important to bear in mind that many examples of efficiently managed public water and sanitation utilities exist, and that the characteristics of the public sector differ among countries. Thus, in many countries, it is not necessarily the public sector per se, but factors such as faulty incentive structures, the politicisation of appointments and management, and other bureaucratic weaknesses that contribute to poor performance. Despite widespread belief in the potential for efficient use of the private sector in some areas of service provision, empirical evidence of the relative merits of private and public management in the water sector is relatively limited.

The most commonly cited advantages of private sector participation are that it brings technical and managerial expertise to the sector, improves operating efficiency, entails injections of capital and greater efficiency in its use, reduces the need for subsidies, and increases responsiveness to consumer needs and preferences. The private sector has significantly better access than governments to capital flows and to the technical know-how that will make a real difference in the provision of critical water services.
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OECD experience suggests that while the commercialisation or involvement of the private sector in selected water supply services can work well, governments must assure vigilance for the public interest. Private participation in the delivery of urban water and sanitation services therefore requires more, rather than less, effective public intervention. Since many aspects of the water sector are not likely to be truly competitive due to the technological characteristics of service provision, public authorities will have to regulate the sector effectively to ensure that services are not overpriced (or under-provided).

Recent experience with private sector participation in non-OECD countries also suggests that there are major obstacles that significantly hinder greater involvement of the private sector on the provision of urban water services. Despite high hopes that private sector participation might help overcome the financing gap for achieving international goals for access to water and sanitation, an increasing number of water sector projects with private sector participation appear to be in crisis, often due to the difficult economic situation in the host country. The number of such projects has been decreasing in three out of the last five years for which data is available (Figure 5.2), and investment flows have been slowing over the last four years (OECD–World Bank, 2002). This has triggered recognition by both public and private actors of a number of systemic problems in the design of projects, for which solutions need to be found. These include weak regulatory set-ups in the host country, the lack of political support for private sector participation, the need for long-term debt finance, low returns on investment, fragmented deal size, poor credit-worthiness of local governments, poor contract and project structuring, and a frequently inappropriate allocation of risks between involved parties.

The following paragraphs outline some of the key lessons from OECD experiences with private sector investment in urban water and wastewater services (OECD, 2000).

- **If a government decides to involve private firms in meeting its responsibility, it also needs to shift from being the manager of the water system to being its overseer and regulator.**

  As the provider of water services, the government manages all aspects of the water system. It decides what is to be built, who is to be hired to do what, how much is to be charged, what quality of water is to be provided, and all related matters. The government takes on a very different role if it decides to involve the private sector. At least for those tasks assigned to private business, the government stops being the day-to-day manager and becomes the overseer of the work. Making this shift is very difficult for many governments. The government’s regulatory capacity becomes a critical consideration for
potential private investors. If this capacity is weak, little international private capital will flow into the sector.

Governments have to remain involved in providing water services, even with private investment. The question for potential private investors is whether the form of the government's continued participation makes the investment more or less attractive than other opportunities. Much of the answer will depend on the clarity and predictability of the government's oversight.

- **Water fees are often too low to support major private investments.**

  Many governments sell drinking water for prices well below the cost of providing the service. In some cases, this is to ensure that the basic needs of all citizens are met, even those who find it hard to pay. In other cases, it is to build political popularity or avoid the civil unrest that might accompany efforts to increase prices. For sanitation services and raw water abstraction, the prices are usually even lower. In each case, it is the political, not the economic, value of the water that often drives the calculation. The impact on potential private investors is clear – the lower the revenue stream, the smaller the investment they will be willing to make.

- **Water users are willing and able to pay for many water services.**

  Since access to drinking water is a basic need, it has great value to individuals. Most urban dwellers already pay something for their drinking water, either through connections to formal, networked systems or via purchases from informal vendors and community-based providers. As a result, the potential revenue streams are sufficient to interest private investors in drinking water services over the long term. Even poorer, non-networked urban neighbourhoods can be viewed as reliable sources of revenue, given that they often pay more for their drinking water than wealthier areas do. More difficult issues arise for other parts of the water cycle, particularly wastewater collection and treatment. While people are often willing to pay to have sanitary wastes removed from their residences, they often value this service lower than access to clean drinking water. Even less consumer value is typically placed on treating sanitary wastes once they are taken away.

- **Addressing the social aspect of water provision is crucial for the success of private sector participation.**

  Ensuring that all citizens have access to clean water, regardless of their ability to pay, is a key goal for most governments and an important prerequisite for the success of private sector participation. In many cases, insufficient measures to protect the poor have led to the loss of social acceptance of private participation, and thus to the collapse of the underlying
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project. If governments wish to subsidise the costs of water for the poor, they should do so in a way that supports income levels, rather than applying universally lower fees for water use. If water rates need to rise as part of moves to improve water services, public funds can help ease the transition. Governments can also provide retirement, relocation, or retraining support for employees affected by the shift to private investment. These types of public support — of limited duration and in gradually declining amounts — can promote the transition to a more efficient water sector over the long-term.

- **Costs and risks are often too high.**

  High capital costs and low revenue streams are just two of the risks investors keep in mind when considering their options. Other major areas of concern include high up-front transaction costs, project-specific risks, and country-specific risks. If these costs and risks are perceived as too high, private operators will be reluctant to invest; in many developing countries, private business will opt in such cases for lower-risk forms of participation, such as management or lease contracts. Such options leave the responsibility for financing of investments with the public sector.

- **Governments and users are often not willing or ready to address risks to investors’ satisfaction.**

  Clearly, private investors must take responsibility for many risks — especially for the business risks that they are in the best position to manage, such as construction costs, treatment plant performance, and the efficiency of billing and collection. However, other risks are more properly assigned to governments or users. How each group deals with its responsibilities in such areas will have implications for the willingness of private firms to invest in particular infrastructure projects, and under which terms.

- **Private water operating companies are limited in number and cannot do everything.**

  Since most governments wish to attract increased technical and managerial experience as well as potentially large sums of new private capital, the main focus of efforts to increase private sector participation has so far been on large international water companies. These firms tend to be viewed as "one-stop shops" for meeting all investment needs of the future system. While this approach can work well, it restricts the potential scope of private investment. International water companies do not have an unlimited capacity for investments. They will seek out and concentrate on the largest, most potentially profitable opportunities — typically municipalities of more than 500,000 people. Hence, investments in poorer or smaller service areas are
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often left out or delayed. New ways need to be found to involve more private investors – of various sizes, nationalities, and experience – in improving water services.

- **Municipalities need to set infrastructure performance standards to reflect local needs and demand.**

  Customers of monopoly suppliers of drinking water rely on governments to control water quality, quantity, and price. Similarly, environmental advocates and raw water users look to governments to set and enforce standards for pollutant discharges to surface- and groundwater. The levels at which any of these standards are set will have major cost implications. Performance standards should strike a delicate balance between the need to protect customers and the environment and the need to maintain water services at an affordable level.

- **Local and central governments need to improve their regulatory capacity.**

  The changing role of government in the water service sector implies a need for municipal officials to take on complicated new tasks, such as negotiating contracts with international water companies, regulating the private delivery of water services, and participating in financing for water projects. Governments need to help the officials make this transition. Possible strategies could include inter-municipal talent pools, reliance on professional advisers, and support from international financial institutions.

- **Choose the form of private involvement that best fits local needs.**

  Many forms of private involvement are possible. There is no universal "right answer" on how to use private investment to help improve water services. Ultimately, governments need to devise arrangements that fit the local context, and some may decide that public-only is best. In such cases, measures (e.g. personnel incentives) may be needed to ensure efficiency reforms are implemented in the public sector. Where the private sector is hesitant to engage, it might be suitable to start with methods that involve low risk for the private operator (e.g. service contracts), moving only later towards more ambitious forms of involvement if considered appropriate.

- **Public awareness needs to be increased.**

  Users will be willing to pay more for water services only if they understand the benefits they will receive. Providing users with information on options, product quality, and costs is therefore vital.