Testing the Waters—A Phased Approach to a Water Concession in Trinidad and Tobago

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The government of Trinidad and Tobago has adopted a two-phase approach to privatizing its water services. In the first phase, a preconcession, or enhanced management contract, was recently awarded through a competitive bidding process. After three to five years, in the second phase, this management contract will be converted to a long-term concession for which the incumbent will have first rights of negotiation. With the management contract now in place for less than a year, it is too early to draw firm lessons. But the two-phase strategy looks like a good choice for a small country with poor sector information and limited regulatory capacity. The preconcession agreement gives the government time to gather information for better risk allocation in the future, develop a long-term tariff regime, and establish a relationship of trust with a private operator—while it also improves service using private sector management. This Note discusses the strengths and weaknesses of the strategy.

Choosing a model

The Water and Sewerage Authority (WASA) of Trinidad and Tobago, a publicly owned and managed company, provides service to the island’s 1.27 million inhabitants. In the past, WASA exhibited all the problems of a traditional public water utility. On average, water was available for less than twelve hours a day. About half the water was unaccounted for, and only one percent of the 240,000 customers were metered. The sewerage system was in disrepair and served only 30 percent of the population. Labor costs accounted for 60 percent of total operating expenses, compared with 40 percent for an efficient water company. Water tariffs were kept very low. Until the mid-1980s, the government had not raised rates for fifty years. WASA consistently failed to generate enough revenues to cover operating expenses, and by the end of 1992, it had accumulated government transfers totaling US$800 million—a burden the government was increasingly unable to bear. So, under immense public pressure for better service, in early 1994 the government started to recruit a private operator to take over WASA’s operations.

There were several complications. First, although privatization had much political support, a long-term, thirty-year concession, typical for the water sector, was daunting, in part because it would require the time-consuming task of amending the company’s authorization act in the months preceding a general election in November 1995. Second, the impending election put pressure on the government not only to improve performance, but also to secure the best deal possible. Third, with poor regulatory capacity and little information on the condition of the system or on water consumption patterns, the government needed time to establish an effective rate setting mechanism or a basis for setting an initial tariff during the competitive bidding process so that bidders could develop reasonable estimates of the long-term risk and probable rate of return.

These circumstances led the government to opt for a two-phase strategy. In the first phase, under an interim management contract, WASA would contract a private operator to provide a management team to meet operational, main-
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tenance, and investment targets and follow an agreed business plan over the term of the agreement. WASA would collect service fees as before, but the new operator would have to fund any operating deficits through a loan to WASA, giving the operator an incentive to minimize deficits. A World Bank loan to the government would provide funds over the contract's five-year term to enable the operator to maintain the system, expand coverage of water and sewerage services, improve billing and collection, and install meters—all in accordance with proposed targets. If the targets are not met, the contract may be terminated early. The operator also would be required to provide the government with the information it needs to design a long-term regulatory regime. The operator would receive a fixed management fee, a variable fee contingent on its meeting annual coverage and service targets, and first rights to the full concession.

Moving to the long-term concession in the second phase would add to the private operator's responsibilities for operation and maintenance the responsibility for financing capital expenditure. The switch to the long-term contract could be triggered before the end of the five-year management contract by a request from either WASA or the operator once the performance targets are reached. Failure by the operator and the government to reach an agreement for the concession would initiate competitive bidding and disqualify the operator from future bidding. In either case, the operator would be able to recover the money lent to WASA during the management contract. Under both the interim and the long-term arrangements, ownership of assets would remain with the government.

**Securing a world-class private operator**

In May 1994, the government retained Banque Paribas and Halcrow as investment advisers to assist in preparing and implementing a strategy for securing private sector participation and in managing the bidding—from preparing the request for proposals to evaluating the bids. In June 1994, in a request clearly setting out the requirements for proposals and the evaluation procedure, prospective operators were invited to submit expressions of interest.

The response was better than expected: twenty-one firms submitted prequalification documents. Of these, five were prequalified on the basis of financial and economic criteria: Anglian Water International (U.K.), Lyonnaise des Eaux International (France), Saur Water International (France), Severn Trent Water International (U.K.)/George Wimpey (Caribbean) Ltd. (U.K.), and Thames Water International (U.K.). The rest either dropped out or were rejected because they lacked credentials in the sector and the financial strength to enter into the second phase of the contract with WASA. The government focused on identifying a contractual partner for the long term.

In November 1994, bidders were asked to submit three proposals—technical, financial, and supplementary—by February 13, 1995. The government required the three separate proposals because it wanted to ensure that it obtained not only good financial bids, but also technically competent management teams.

The technical proposal, evaluated first, named the bidders' candidates for top management and set out a business plan, a plan to increase the hours of water service, and a series of performance targets based on requirements specified in the request for proposals. To test the private sector's appetite for risk, the request left it to the bidders to determine what share of the management fee would be paid as a fixed amount and what share as a performance bonus. More points went to those willing to assume greater risk by relating their remuneration more to performance-related targets than to fixed fees. All five firms earned the minimum score or better on the technical proposal, qualifying for the next stage.

In the financial proposal, each bidder specified the amount of the nonguaranteed loan that it would extend to WASA to cover operating defi-
cits, the interest rate on the loan, and a management fee. While the financial terms of the winning bid have never been made public the method for evaluating the financial proposals was as follows. Say a bidder proposed a US$20 million loan at 10 percent interest and a US$10 million management fee. The management fee would be subtracted from the discounted loan (US$18 million), yielding US$8 million. This amount is worth forty points, five points for each million dollars. Thus, this scoring method awards more points for higher loans, lower interest rates, and lower management fees.

The supplementary proposal was designed to serve as insurance against a no-bid situation if the terms of the management contract turned out to be unattractive to bidders. In this proposal, which the government was aware would add an element of subjectivity to the evaluation process, bidders could propose their own contract design. The supplementary proposal also included a request for proposals for a water treatment project to serve an industrial town in Trinidad and Tobago. To minimize any bidder concerns about the transparency of the process, the supplementary proposal could be opened only for the top financial bid or for the top two bids if they were within 5 percent of each other.

Once the rankings were finalized at the beginning of April, the supplementary proposals for the top two bidders were opened. Severn Trent/Wimpey was selected by the end of April, and WASA immediately started negotiations with the winning bidder on the finer points of the agreement. But in the end, the management contract did not take effect until April 1996, after the new government elected in November had had time to examine and endorse the contract.

A parallel track for reform

While the recruitment of the preconcession operator went forward, the government began a series of initiatives to improve WASA’s economic viability. In 1994, it granted WASA the right to increase tariffs by 35 percent for customers receiving water for more than twelve hours a day—providing an incentive for the operator to expand coverage and ensure reliable service. The tariff increase was introduced in 1995, before the new operator came on board. This timing was meant to separate the two events, to ensure that the politics of the increase would not sour the arrival of the new operator in the eyes of the public. But the government also judged that the tariff increase was needed to attract high-quality bids. It estimated that the new tariffs, along with the expected improvements in billing and collection, would generate cash flows sufficient to meet future investment needs.

WASA continued to reduce its staff through voluntary separations and retirements, an effort initiated in 1992. The government assumed responsibility for a large share of WASA’s current debt service, and the World Bank provided a loan in August 1994 to assist WASA with emergency repairs of leaks and purchases of essential parts until the management contract took effect in April 1996.

The government also undertook institutional reforms. It made the Water Resources Agency, the division of WASA responsible for water quality, an independent government agency, and it has taken steps to amend WASA’s authorization act to accommodate a private sector concession. In addition, the government continued its efforts to reorganize the Public Utilities Commission, focusing water regulation activities in one entity and setting up better means for monitoring the private operator. It is also revamping the tariff setting mechanism, to allow cost recovery and adequate profits.

The prequalified bidders reported that they considered the government’s early reform efforts to be credible, a key factor in the great interest in bidding.

Conclusions

The case of Trinidad and Tobago shows that even for small countries there can be strong private sector interest in providing water and
sewerage services. Several factors account for the enthusiastic response from bidders. The government’s request for proposals clearly specified the rights and responsibilities of the operator as well as its own objectives and requirements. The government went to great efforts to develop an honest assessment of WASA’s prospects and to make relevant materials available to bidders. It responded to numerous requests for additional information and met often with bidders to clarify issues.

The experience of Trinidad and Tobago also suggests that with careful preparation a country can attract private sector interest even before an institutional framework is fully established. Although it is usually recommended that an independent regulatory system and an appropriate legal framework be in place before private sector participation is introduced, this typically makes heavy demands on the administrative and institutional capacity of countries.

Trinidad and Tobago started reform with limited regulatory capacity, and because of a desire to move quickly, the government proceeded with private participation without developing a full-fledged regulatory regime. Instead, it incorporated into the contract such regulatory aspects as performance standards. This feature was enough to attract world-class operators willing to finance working capital and assume high operational and commercial risks. As the first phase of the concession is carried out and more information about the system and about consumption is obtained, the government will be able to establish an appropriate regulatory and tariff structure and other necessary preconditions for the full concession.

As implemented in Trinidad and Tobago, the phased approach to a concession appears to be a good alternative for countries unable to move immediately to a full concession. It provides the benefits of private involvement in the water sector in the short term, and it allows the government and the private operator time to develop the terms and conditions of the more complex thirty-year concession. If both parties opt for the longer-term arrangement, the preconcession would have provided them with the information and experience needed to efficiently allocate risks. In addition, the approach permits the government to demonstrate its credibility as a contractual partner and thereby improve the terms and broaden the scope of future partnerships with the private sector.

The two-phase approach also has some drawbacks. First, during the management contract, the government, not the private operator, is still responsible for financing the much-needed rehabilitation and capital improvements. Second, the long-term operator is in effect selected on the basis of criteria for a short-term contract. If there is no competitive bidding for the long-term concession, the government cannot be sure it is obtaining the best arrangement possible. Retaining good financial advisers for the negotiation of the concession and using concession contracts executed in other countries as benchmarks can help in getting a satisfactory deal.

It also remains to be seen how well the government implements the reforms needed to allow the concession to move into the second phase, when the private sector would begin to make its first significant investments. Postponing more extensive private participation runs the risk that political resolve will weaken and that gains made in the first phase could be reversed. But Trinidad and Tobago’s two-phase approach at least reduces the risk of reversals by contractually locking the government and the private operator into a long-term relationship.

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