There is growing recognition that the private sector can do much to help meet infrastructure needs in developing countries. But the countries most in need of the private sector’s assistance—technical, managerial, and financial—are those least likely to be attractive to it. This problem is particularly acute in the water sector.

Water has historically been hugely underpriced in most developing countries. Though subsidized water tariffs generally do little to help the very poor (who often lack formal water connections), governments have clung to them in the belief that they are doing the socially appropriate thing, and proposed tariff increases tend to meet with vociferous opposition from the middle class and wealthy. Water systems are often poorly run, sustaining losses through physical leaks and poor collection systems. (Many developing country water utilities collect revenues on as little as a third of the water that they supply.) And with many of the assets underground, the actual state of systems is often unknown. Regulatory frameworks are often lacking, incomplete, or internally inconsistent, and the relevant skills thinly spread. Because of the political sensitivity of the sector, governments often have little credibility as regulators or contractual partners. There is little trust that they will maintain a favorable operating environment and a tariff yielding a reasonable rate of return.

This is not a setting conducive to the substantial, long-term, sunk investments needed to build or rehabilitate infrastructure. Nor is it a setting in which the private sector will happily take on commercial risk. All these problems occur to some extent even in relatively well-endowed developing countries—countries in which incomes are rising, there is an established, professional bureaucracy, and the government has some track record of fair dealing with the private sector. But they are particularly acute in the poorest countries. Some of the poorer countries of Central and Eastern Europe, for example, and Sub-Saharan African countries emerging from long periods of internal conflict suffer not only from very low incomes, but also from limited administrative capacity and a limited or unfavorable government track record.

While much stands in the way of private provision of water services in such countries, there are a number of ways to reduce the costs and increase the attractiveness of contracting. There is, of course, no magic formula that a country can apply to instantly transform itself into an attractive destination for large sunk investments. But the options below each target some aspect of the problem and, individually or in combination, may speed transformation.

**Option 1: Taking a stepwise approach**

Some countries are considering a stepwise approach to private sector involvement—beginning with a management contract and building up to a concession or divestiture. Albania and Angola, for example, are weighing this approach. Trinidad and Tobago recently implemented a management contract for water and sewerage services and plans to move to a contract involving greater private sector risk in three to five years’ time. And in 1989, Guinea entered into a lease contract for water services in seventeen cities and towns, with the hope of moving to a concession when the lease comes up for renewal in 1999.
The virtue of the stepwise approach is that it allows gains from private sector involvement while providing the government time to address tariff, regulatory, or information problems in the sector. For example, the government may introduce gradual tariff increases over the life of the management contract, use the time to build up regulatory capacity and implement regulation, or require the contractor to build a database on the state of the water system. In each case, the effect will be to create an environment a little more conducive to private sector investment and risk taking.

But while stepwise approaches are an attractive way to secure at least some private sector involvement in risky countries, there is no guarantee that they will get beyond the first step. Because decisions about involving private companies in the water sector can be politically costly, governments may be unwilling to take the next step beyond a management contract, especially if they have not raised tariffs to cost recovery levels during the term of the contract. Governments may also be lulled into a false sense of security if the management contract provides just enough gains to keep key voter groups happy and feel that they need do no more—even if many people still lack adequate service. Management contracts can be good at improving services for those who already have connections, but typically do not do as much for those without connections, who are often less politically powerful. Transitional arrangements should therefore include incentives for the next steps, such as sunset clauses on government roles or triggers in the contract for reallocating risks between the parties once specified conditions have been met.

In stepwise processes that replace low-responsibility, low-risk contracts with high-responsibility, high-risk, and potentially high-return contracts, the question of rebidding necessarily arises. While there may be real competition in awarding the initial management contract, maintaining competitive pressures during the transition to a lease or concession is more difficult. The company that wins the management contract will naturally have an advantage in bidding for subsequent contracts, and seeing this, other potential bidders may stay away. But barring that company from bidding for the next phase may reduce interest in bidding for the management contract.

In either case, competition is likely to be limited or absent during the shift to a more complex contract. This raises the stakes in the bidding of the original contract. Ideally, this contract should be let with all the seriousness of a concession or divestiture. But the informational deficiencies justifying a stepwise process in the first place generally preclude such a sophisticated approach. Much work remains to be done in finding innovative solutions to this cluster of problems.

Thus, while stepwise approaches have many attractions—and may be the only viable option for poorly endowed countries—their design and implementation are not straightforward. Much attention must be given to creating incentives to take subsequent steps and mechanisms for maintaining competitive pressures on the initial contractual partner.

**Option 2: Simplifying contracts**

In countries with limited administrative capacity (even more than in countries that see themselves as administratively competent), simplifying contracts can do much to simplify monitoring and reduce uncertainty. One of the attractions of management contracts is that, in principle, they need not require the kind of regulatory and monitoring infrastructure required by leases, concessions, or divestitures. But if a management contract is to yield real improvements in performance, a good system of incentives and monitoring is essential. There are two key requirements for a good system: clear and indisputable performance indicators and a monitoring agency or official with the skills and budget to do the job, and the strength, integrity, and autonomy to do it independently.

Management contracts often contain long laundry lists of performance indicators, providing
for bonus payments when targets are met or exceeded. But finding indicators that offer a fair and indisputable basis for managerial incentives is difficult. Many of the conventional indicators of water utilities’ performance—such as unaccounted-for water and staff productivity—depend on factors that may be only partially within the control of a management contractor. Success in reducing physical losses may depend in part on the government’s investing in rehabilitating pipes. Success in improving collections may depend on the government’s paying its own bills and supporting a policy of disconnection for nonpayment. Success in reducing operating costs may depend on the ability to lay off workers. Moreover, the measurement of some indicators can lead to disputes. Which definition of unaccounted-for water is to be used? If metering is incomplete or faulty—as it generally is—how are water losses to be measured?

There is no simple solution to these sorts of problems. Generally, though, there is a case for moderation in using indicators—sticking to those least likely to lead to measurement problems and disputes—and for adding more direct incentives, such as revenue sharing.

Option 3: Contracting out parts of the regulatory function

Many developing country governments have limited administrative capacity, little or no regulatory experience, and little tradition of creating independent regulatory agencies. As a result, several countries are considering contracting out parts of the regulatory function—the collection and processing of data on company performance. Angola is considering this in the context of preparations for a management contract. And the Philippine government, which is preparing twin concessions for water and sewerage in Manila, plans to contract out a range of performance auditing functions.

Contracting out the task of gathering and processing the detailed information necessary to carry out the regulatory function can significantly reduce the government’s administrative burden. It can also increase the credibility of the regulatory process if the auditing company has a strong reputation for quality and integrity. Not all aspects of the regulatory function can be contracted out, however. No regulatory rule or contract for private participation, no matter how precisely written, can remove all discretion from regulatory decisions, and the exercise of this discretion cannot be contracted out. Contracting out parts of the regulatory function can, at best, cast greater light on the exercise of that discretion.

Option 4: Increasing predictability in the use of discretion

In poorly endowed countries, private investors perceive their risks as high in part because of concerns about how regulatory discretion will be used, including in revising and renegotiating contracts. Even if a contract were bid on the basis of perfect information about the current status of the water company’s assets and about new investments needed, the future would hold uncertainties that could not be handled by contract. And an initial contract is usually based on highly incomplete information about such factors as the condition of underground assets and future investment requirements. Careful provision must therefore be made to deal with unexpected events over the life of the contract.

Provisions must be carefully specified for renegotiating aspects of the contract and for adjusting contractual terms over time. Over the life of the partnership, these provisions can turn out to be even more important to success than the initial terms of the contract. Such provisions need to specify at least four elements:

- The conditions under which adjustment of terms or renegotiation may occur (including penalties to curb frivolous renegotiation).
- When and under what conditions a contract must be renegotiated—as opposed to when price or service adjustments are made by agreement or by regulatory discretion.
- The process for initiating and conducting renegotiation.
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The processes to be followed and the authorities to be appealed to in the event that the parties to the contract cannot agree on how to resolve an issue (arbitration provisions).

In countries with no history of regulatory or judicial independence, clearly specifying processes for articulating and resolving disputes is particularly critical. International arbitration is often advocated as a means of offering comfort that disputes can ultimately be resolved in a neutral forum. But such arbitration is costly, and for most disputes—and for many smaller contracts—it may not be feasible. In these cases, there may need to be more reliance on the incentives for dispute resolution implicit in arbitration rules.

The need for realism

The main objective of projects to secure private sector participation in the water and sanitation sector is to get better services to consumers at lower cost. In most developing countries, the poorest consumers face an appalling situation. Many lack access to potable water and any kind of sanitation. In many cities, the wealthy receive piped water at below cost, while the poor must rely on unsafe water at very high cost. In Luanda, where recipients of piped water pay less than a cent per cubic meter, people without connections may pay as much as US$16.00 per cubic meter for untreated water delivered by tanker.

Involving a private sector partner in the delivery of water and sanitation services is often the only sustainable way of making a dent in these kinds of problems. But it is easy to lose sight of this (obvious) objective in the course of designing, implementing, and monitoring a private participation arrangement. Governments often start with a fear that the private partner will be a rapacious profit-taker. Considerable efforts will (rightly) be made during project preparation to guard against possible abuses of monopoly power.

But there is often a sharp difference between what private companies see as the minimal return necessary to go into business in a risky country and what governments view as an acceptable level of profit. (Advisers to developing country governments considering private participation in water will all be familiar with the gasps of disbelief and indignation when they first voice assumptions about expected returns on equity.) Governments that have happily (or at least blindly) tolerated high levels of rent seeking and wasteful behavior by public water company officials can become positively puritanical about relatively modest profit taking by a private company. This is not to say that private companies with a monopoly to supply water services should be allowed to take any level of profit that they choose. But governments should be realistic about the profits that they should allow, recognizing the need of their private partners to earn a reasonable return and to be rewarded for the risks that they shoulder.

1 For definitions of different kinds of private sector participation, see Pierre Guislain and Michel Kerf, "Concessions—The Way to Privatize Infrastructure Sector Monopolies" (Note 59, October 1995).
2 See Helen Nankani, "Testing the Waters—A Phased Approach to a Water Concession in Trinidad and Tobago" (Note 103, January 1997).

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