

Development-Driven Public-Private Partnerships in Water



Emerging Priorities from Second Roundtable Discussion

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Financing for Development Initiative
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The World Economic Forum's Financing for Development Initiative grew out of the conclusions of the UN-sponsored Financing for Development conference in Monterrey in 2002 which called for greater coherence between public and private actors to achieve development goals. The World Economic Forum initiative has sought to generate concrete recommendations addressing what works and what does not in public-private partnerships through a series of practitioners' roundtables. Work has focused on three sectors: health, education and water.

The Second Roundtable on Development-Driven Public-Private Partnerships in Water and Sanitation took place in London, United Kingdom, on 10 and 11 May 2005. The meeting built on the discussions at the previous Roundtable on this topic in South Africa in October 2004 and sought to define a series of recommendations for partnerships based on the experience of a diverse group of practitioners. The participants were drawn from the public and private sectors and included representatives of multinational water companies, public utilities, commercial lenders, development institutions and bilateral donors, social enterprises, academia and non-governmental organizations.

This document captures the nature of the discussion at the Roundtable. It will be integrated into a cross-sectoral report to be presented to the 60th UN General Assembly Meeting in September 2005, and will contribute to the MDG+5 discussions, as well as the World Economic Forum's Annual Meeting 2006 in Davos.

The diversity of professional backgrounds of the participants ensured a wide-ranging discussion covering the full spectrum of partnership arrangements, from community-level micro-projects to contracts and financing arrangements suitable for major urban centres. While all of these types of arrangements have a role to play in reaching the poor and helping to meet the MDG targets for water and sanitation, it was clear from the discussions that greater emphasis needs to be placed on innovative financing solutions for peri-urban and rural areas where access to water and sanitation is significantly lower.

A pivotal conclusion is that the success of public-private partnerships (PPPs) depends on choosing the appropriate partnership type to suit the size or scale of the project, along the spectrum from the village level in poor rural areas to the metropolis.

Scale, in turn, affects all aspects of PPP design, from the selection of the partners to the sources of financing. Differences in conditions in urban, peri-urban and rural areas can make it difficult to design projects that respond to the needs of all stakeholders living in such different conditions, although a strong view was expressed during the Roundtable in favour of integrated approaches. Participants agreed that solutions could be found if all the relevant dimensions of the projects were taken into account and stakeholders had a strong base of common interests.

Discussions revolved around eight major dimensions of water PPPs, each of which is useful to understand the issue of scale for successful and sustainable PPPs that reach the poor and contribute to the attainment of the MDGs. These dimensions are:

- 1) availability of information;
- 2) effectiveness of the PPP process;
- 3) risk transfer to the private sector;
- 4) social versus commercial objectives;
- 5) role of multilateral agencies;
- 6) partner commitment;
- 7) scope of partnerships; and
- 8) regulation. Each of these issues is discussed in turn below.

1. Availability of Information

Information asymmetries can be a major impediment to the development of successful partnerships. Echoing the comments of the Operators' Roundtable organized by the World Bank (December 2004), participants put great emphasis on the availability of sufficient, accurate information to design successful PPP projects in the water sector, but noted that information usually has to be collected at the municipal level and is seldom effectively transmitted upward.

Before considering private sector participation in the treatment and supply of water, government and sub-sovereign entities need to develop **information about conditions and creditworthiness in the water sector**. Emphasis was placed on the need for governments to:

- Collect and consolidate information about utilities' performance, including details of revenues and existing assets;
- Lead a benchmarking exercise of utilities' performance to facilitate comparison between utilities;
- Build models to estimate future demand; and
- Assess the role of the informal sector in water provision.

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While the public sector often fails to see the point of collecting this data before involving the private sector, it can be instrumental in allowing governments and municipalities to **assess the advantages of PPPs against pure public sector reform options and understand what PPPs can and cannot bring**. To further this understanding of the sector and of available PPP options, information has to be made available to entities about:

- Options for public sector reform in comparison to the involvement of the private sector;
- Available options for improving management and operations;
- Financing models and sources of available finance; and
- Existing successful PPPs in developed and developing countries.

Addressing the information deficit of the public sector would also be useful for the private sector. Before entering into a partnership, the private side needs access to **performance information** about the utility it is proposing to get involved with; this information should already have been collected for the public sector in assessing what to expect and require from a PPP project. This information exercise will also **raise the visibility of projects** and should help the private sector to identify potential PPPs.

Participants recognized that there was a tendency to build ‘gold-plated facilities’ in the 1990s, which ignored the need to match technologies and needs with financial sustainability. There is now a wide choice of low-cost technologies and techniques that can be adapted to the needs of poor communities in rural and urban areas, such as the use of rain harvesting, which has been successful in India. **Information about adaptable technologies should be made widely available** and integrated into project design schemes. Identifying available technologies and what they can offer could prove instrumental in fostering new partnerships.

Finally, **providing consumers with information on utility performance** was also identified as a necessary condition for a successful partnership agreement. Solutions ranging from public hearings to transparent contracts and open-book accounts were suggested.

2. Effectiveness of the PPP Process

Partnership arrangements in developing countries have emerged in an ad hoc, sometimes chaotic, manner. Most participants agreed that **a large number of projects have been badly prepared** and could benefit from the earlier involvement of private actors to increase deal flow and quality.

There was general agreement about the **low quality of advice for project preparation**. Private financiers and developers pointed out that consultants often do not have the requisite practical experience in the sector to prepare projects, while developers themselves are unwilling to take on this role if the project is to be subjected to competitive bidding. Private financiers argue that this mix of upfront costs and uncertainty is keeping private operators out of the early stages of the development of the PPP market.

However, there was **no consensus on how to bring in private operators early without addressing the issue of competitive bidding**. While direct negotiation may reduce transaction costs, evidence points to the risks of inefficiency and corruption in these PPPs as well as to their political fragility, a point repeatedly made by development bankers. The procurement rules of international financial institutions were also seen as a barrier to the engagement of the private sector.

The public sector’s role in developing the market for PPPs should include gathering and consolidating information and setting up **institutions that are both responsive to local needs and meet the need for coordination** by striking a balance between decentralization and consolidation, such as regional utilities or river basin authorities. Central governments should support project preparation by setting up a dedicated agency with the necessary skills to structure PPP projects and prepare them for private financing.

The public sector can also help develop the PPP market by concentrating on **improving the creditworthiness of municipalities and utilities** and encouraging the development of credit rating systems before involving the private sector.

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3. Risk Transfer to the Private Sector

All private sector players, from equity investors to lenders and business associations, emphasized that **partnerships established during the 1990s transferred all risks to the private sector** and that this was not an arrangement that private players were willing to replicate. While private sector players are willing to take on commercial risk, which they feel well positioned to handle, they expressed their **reluctance to be exposed to political, regulatory and foreign exchange risk**.

Development banks put great emphasis on the risk transfer process and **the necessity of a correct understanding of risk transfer by the public sector**. This issue of risk sharing is complicated by the divergence in perceptions between public and private partners of the nature of risks incurred. For developing country governments, past PPPs aimed to shift capital investments and responsibility for service to the private sector in order to reduce government liabilities. Private investors also pointed out that emerging market PPPs usually transferred responsibility for servicing pre-existing debts to the private operator as well as expecting private investors to compensate for years of underinvestment by public utilities. However, PPPs invariably remain contingent liabilities for governments in the face of the necessity to guarantee the continuity of public services. Participants noted that **governments seldom understand the circumstances in which risk transfer to the private sector would represent value for money**.

Citing evidence from OECD projects, private sector actors explained that while PPPs can lower the overall level of risk (both operational and financial) **the responsibility for PPPs' viability must remain with the public sector** and should be explicitly recognized. Careful analysis was then required to determine what the **optimal level of risk transfer to the private sector** should be.

A further conclusion was that **public and private sectors do not just share existing risk; they may also expose each other to new risks** which are not always recognized or understood.

4. Social versus Commercial Objectives

Development-driven PPPs must achieve the double objective of being commercially and **financially sustainable and achieving the social objectives of extending service to the poor and achieving the Millennium Development Goals**.

In developed countries, PPPs are commercially-driven: "In the UK, we are talking about investment grade projects with a high leverage that attract institutional investors. This lowers the costs of projects because debt is cheaper than equity." From the financiers' perspective, the preferred PPP model is one which **guarantees a revenue stream to the private operator based on performance**. Ideally, the operator has a single point of contact and a single 'client' on the government side, either at the municipal or central government level. All project financiers agreed that dealing directly with consumers added risks and complexities that were not welcome. Project operators and development institutions take a different view, recognizing that the **creditworthiness of end users in developing countries is often better than that of municipalities**.

Under the right conditions, there is no shortage of funds available from private banks for water projects. International financiers confirmed that **as long as the project is expected to generate a strong, stable revenue stream** a wide variety of financing instruments and structures can be used, from straight corporate financing (for projects with at least US\$ 20 million of capital investment) to limited recourse project finance (beyond US\$ 100 million). Indeed, project financing can be well suited to projects in the water sector, where there are high upfront capital costs but low operations and maintenance expenses.

There was broad consensus on the **need to strengthen local financial markets to provide both long-term debt and equity** financing for projects: "The development of local capital markets is not a quick-fix but is the most important step to finance the water sector." In middle income countries and some low income countries, there is plenty of liquidity in local financial markets that can be tapped for water infrastructure investment. Emphasis should

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be given to helping municipalities and utilities to access the bond market, and dedicated revolving funds can be used to accelerate the process of getting funds to projects. By raising finance locally, projects **can avoid the risk of devaluation** which has jeopardized the viability of some of the water sector's largest PPPs, both in Asia and Latin America.

Integrating social considerations into PPPs poses distinct challenges. One approach is for the private operator to use cross-subsidies to provide water to low income communities below cost, but operators have found that cross-subsidies are often inefficient and benefit higher income groups more than the poor. **Whether cross-subsidies can balance social and commercial needs also depends on the geographical scope of the partnership.** If the partnership covers peri-urban or rural areas, private operators argue that the project will only be financially viable if there are specific, transparent subsidies from the government or donor directly to the operator. These subsidies can be integrated as projected project cash flows by financiers, although the risk of non-payment by a municipality remains high. However, from the point of view of governments and grassroots organizations, a direct subsidy to the private sector may not be politically acceptable.

Subsidy design is of critical importance in balancing commercial and social objectives. Subsidies need to be designed carefully to ensure that they **do not reduce the incentives for private service providers to operate efficiently and roll out services to the poor.** Subsidies can be directed towards operating or capital expenses. It should not be assumed that the government should cover all capital costs, but all subsidies should be transparent and explicit. The 'minimum lifeline' allocation in South Africa or direct transfers to low income households, as in Chile, were two suggested models.

At the other end of the spectrum of PPP projects, there was general agreement that the government would have to provide subsidies for small-scale or rural projects, although social entrepreneurs pointed out that markets for water-related products and technologies can and do function with no

intervention from the government. **At this level, however, water investment projects do not generate the level of revenues needed to be able to attract private finance.**

Concerns were expressed about the effectiveness of aid targeting, especially in rural areas where project allocation can become politicized. Practitioners active in rural areas pointed out that private operators can provide more efficient project management and more equitable implementation than local governments.

5. Role of Multilateral Agencies

Two strands of opinion emerged on the role of multilateral agencies (MLAs) in water PPP financing. On the one hand, MLAs can provide grants to support subsidies. However, these are usually limited to a five to eight year duration, even though a stream of subsidies may be necessary throughout the life of the project to ensure financial sustainability. Experts also pointed to the **loan-driven culture of development banks.** As projects should be looking for long-term commercial stability, MLA financing may not be optimal.

Discussions echoed the recent **emphasis on the use of guarantees** from MLAs in the development debate. These can be extremely effective as a way to leverage scarce funds, but experienced practitioners expressed scepticism about the usefulness of political risk guarantees. They also raised the concern that MLAs tend to be reluctant to use their influence to pressure governments to honour commitments. These guarantee products have been developed but take-up has been slow, in part as a result of the way guarantees are treated in government accounts.

Multilateral and bilateral development partners have another important role to play in ramping up quality and coverage in the water sector by encouraging governments to integrate water and sanitation priorities into poverty reduction strategy papers (PRSPs) and budget planning.

6. Partner Commitment

A broad consensus emerged that **water and sanitation is still a low priority for national**

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governments, well behind health and education as a social sector focus. This is reflected in the low profile of water and sanitation goals within most PRSPs.

There has been increased awareness of water and sanitation at the rhetorical level, but this still has to be matched with concrete steps in many countries to update or develop national strategies for the sector, including the development of targets and performance indicators. It was suggested that all governments could show their commitment to working towards the achievement of the Millennium Development Goals concerning access to water and sanitation by raising the importance of these issues in national policy.

Responsibility for water and sanitation provision in many countries has been devolved to the municipal level but **national governments can still play an important role in encouraging improved performance**. This may involve engaging a private sector counterpart, for example by linking financial transfers from central government to improved performance levels of utilities and by improving information flows.

Private operators emphasize that **governments have often shown little commitment to meeting contractual obligations**. Political changeover poses a particular threat to the stability of long-term PPPs as newly elected governments do not respect commitments made by their predecessors. Accusations of corruption have also undermined the sanctity of contracts and led to prolonged and aggressive contract renegotiations, demonstrating the need for transparency in the awarding of PPP contracts. Wavering support from political leaders makes it all the more important for private operators to build strong relations with current and potential customers who may then be a source of support in any dispute with political leaders.

International water operators again confirmed that they now see their role as operators and managers of water projects in the developed world and are **reluctant to invest equity outside their home markets**. However, some participants felt that this

reduced role would weaken the public-private partnership: "Commitment means investing equity. Otherwise it is a commitment to serve the poor at somebody else's expense." The question of how to draw private investors back, however, has not been fully answered. Successful PPPs depend on shared expectations among all the project's stakeholders. The **central expectation of private operators and financiers is solid financial performance: Governments and communities have a more complex set of objectives which need to be identified and addressed through careful project design**.

The **level of 'social responsibility' of private companies** was a controversial topic. On the one hand, many development practitioners called on the private sector to take the initiative in developing pro-poor projects and to integrate the expansion of services to the poor in their commercial investments. Financiers, on the other hand, see the commercial viability of the project as fundamental and believe that including 'non-profit' elements into projects undermines their ability to attract financing. The companies themselves are taking a two-stranded approach: they insist that any contractual requirements to supply services below cost need to be fully covered by a guaranteed stream of subsidies from the government or donors. At the same time, several companies are engaged in dedicated pro-poor programmes in the context of their corporate social responsibility strategies.

7. Scope of Partnerships

Across the PPP spectrum, partnerships may involve different combinations of actors. Projects in rural areas are likely to involve small-scale private enterprises in producing and distributing new technologies as well as delivering services. At this micro level, **direct community participation was deemed essential in the design and monitoring of projects** if they are to meet local needs and prove sustainable. Community involvement can be included as a contractual requirement. However, as projects move up in scale, it may be more appropriate for a government representative to play the role of interface between the private business and the community groups to streamline the

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process. **Some commercial lenders were radically opposed to community involvement** because of its impact on project development timelines and associated costs.

Other participants agreed that community participation was also essential to project success at the other end of the scale and suggested that **customers should be formally involved in the regulatory process through consultative committees or public hearings**. Where private operators do not devote resources to developing customer support, they may be vulnerable to challenge from well-organized civil society groups that can mobilize the public against any kind of private sector involvement. It was suggested that private operators could reduce risk by building trust in the community.

Small-scale water providers (SSWPs) play an essential part in providing services to poor communities in large urban areas as well as rural regions. Large private sector operators can cooperate with SSWPs through formal or informal arrangements to roll out coverage to low income areas.

It was agreed that transparency and accountability at all levels were vital to the sustainability of projects. National level initiatives such as a right to information and the institutionalization of public hearings have been very successful in some countries, while strengthening national civil society is essential to hold politicians to account.

8. Regulation

There was a **strong consensus on the need for economic regulation** for public and private water service providers to protect the consumer from monopoly and to support the financial viability of firms. However, there is divergence on the following questions:

- Whether all countries should be moving towards **an optimal model of regulation**, such as an independent regulatory agency, or whether the regulatory design should depend on national conditions;
- Whether the regulator should have **a specific 'pro-poor' objective**. Some argue that it is preferable to address poverty concerns at the policy level;

- Whether **regulation is needed for rural areas or for SSWPs**. The costs of regulating small providers are high and it may not be necessary if they are not monopoly providers. However, their role should still be acknowledged in the regulatory design.

Most aspects of regulatory design will depend on the specific national conditions, such as whether the regulator is single or multi-sectoral and whether the regulator is at the central, state or even local level. In all cases, **the regulator should monitor more than one service provider** to be able to compare and benchmark.

Concluding Remarks

The popular view that water and sanitation projects are too risky for private sector involvement does not do justice to the **huge variety of public-private community partnerships that are currently being developed and implemented in developing countries**. From the clever use of simple technologies in rural areas to sophisticated financing structures for utility bond issues, private and public actors can find successful arrangements for the delivery of water services to consumers and for extending service to the poor.

Recent debate on private sector involvement in public services (including water and sanitation) in developing countries has tended to focus on the necessity to find a 'new model' following the decline of investor's interest in emerging market PPPs.

However, the discussions held at this Roundtable suggested that well-established PPP models with good track records already exist, and that the environment within which a PPP is created along with the expectations of partners and the ability to understand and commit to each other are pivotal determinants of success or failure.

At the same time, the debate has broadened to include pure public sector reform options and **the exploration of ways to engage communities to match project and consumer needs** and to avoid social and political backlash.

Each new project faces the challenge of establishing common ground between the partners and establishing a clear and workable framework that takes into account all of the dimensions described here and summarized in the table below that practitioners consider to be of key importance.

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This overview has been compiled from information gathered during the Roundtable in London. Its purpose is to provide both a summary of the main topics covered in the Roundtables and insight into new directions and outstanding issues. An interim report with the overall findings of all roundtables is available; the final report will follow.

This document was drafted by Olivia Jensen and Frédéric Blanc-Brude, and edited by the Forum project team, incorporating comments from a number of roundtable participants.

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The size spectrum of public-private partnerships for water and sanitation in emerging markets	
Urban/Large-scale	Rural/Small-scale
Water use(s)	
Household consumption Input for industrial production	Household consumption Input for agricultural production
Available information and technologies	
Information about existing assets and revenues Piped network	Information about community preferences Variety of technologies
Effectiveness of the PPP process	
Streamlined solutions	Ad hoc solutions
Role of MLAs	
Honest broker, Guarantor	Grant (subsidies)
Risk transfer to the private sector	
Potential commercial viability	Not realistic as commercial propositions
Partner commitment	
Equity (public and private)	Project management (private), Subsidies (public)
Commercial versus social objectives	
Private finance (local or foreign) Level of return (equity)	Public finance (government or donor) Level of subsidy
Regulation	
Monopoly Need for economic regulation	Multiple providers Maybe no need for regulation
Scope of partnership	
International company/public utility Consumer participation in monitoring performance	Small private sector/community management Community participation in design and monitoring



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