

# Development-Driven Public-Private Partnerships in Water



## Emerging Priorities from Roundtable Discussions

World Economic Forum  
Financing for Development Initiative  
in cooperation with



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## Background

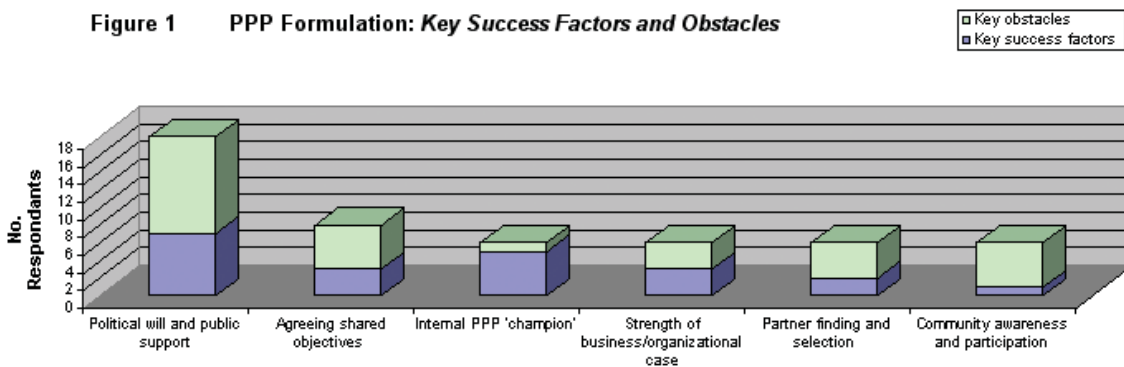
The UN-sponsored Financing for Development conference in Monterrey in 2002 concluded that greater coherence between public and private actors will be required to achieve internationally-agreed development goals and to overcome the inadequacies of development finance. As a follow-up to this conference, the World Economic Forum's Global Institute for Partnership and Governance and the UN Department of Economic and Social Affairs have undertaken the first in a set of practitioner-driven, multistakeholder roundtables to determine where some of the greatest opportunities lie for harnessing public-private partnerships (PPPs) to advance development objectives. These gatherings are examining the question of what works and what does not in the formulation and management of development-driven PPPs. Work has focused on three sectors: health, education and water. Emerging issues from the first roundtable discussion on PPPs in water are summarized in this document.

A second series of roundtables is planned in April and May of 2005. The learning from these events will be presented to the 2005 UN Financing for Development High-Level Dialogue, the next High-Level Plenary Meeting of the sixtieth session of the General Assembly and the World Economic Forum's Annual Meeting 2006.

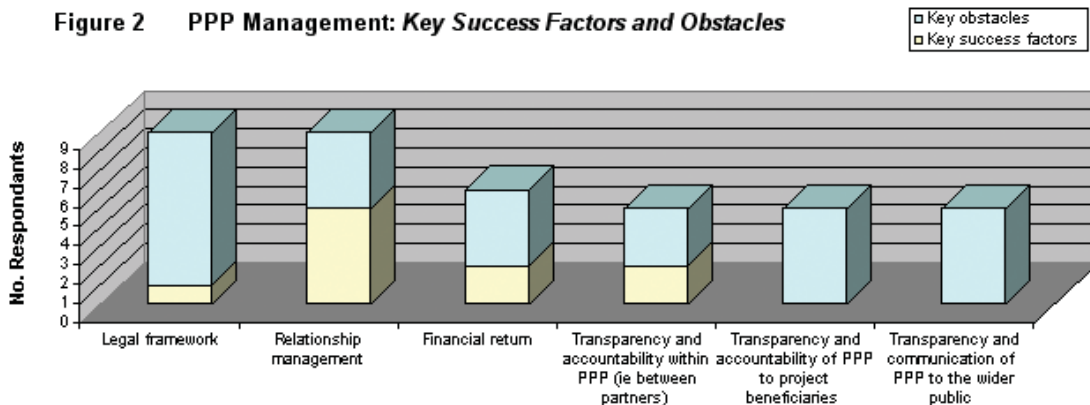
## Key Success Factors and Obstacles in the Partnering Process

The first Roundtable in Durban, South Africa (18-19 October 2004) was attended by 35 practitioners. These individuals represented water regulators, private water companies, development finance institutions, public utilities, ministries of finance, academics and various not-for-profit organizations. From a choice of 63 variables, participants were invited to identify which they considered to be the key obstacles or success factors in formulating and managing development-driven PPP arrangements in the water and sanitation sector. The results are presented in *Figures 1 and 2*.

**Figure 1 PPP Formulation: Key Success Factors and Obstacles**



**Figure 2 PPP Management: Key Success Factors and Obstacles**



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Regarding the process of formulating PPP arrangements, **most uniform was the importance placed by the participants on achieving sufficient political will and public support to overcome concerns within society over private sector involvement in water and sanitation provision.** Key constraints to the longer-term management of PPPs were identified as an absence of a catalytic legal framework; difficulties in relationship management between the various, often non-traditional, parties; and the viability of financial returns. Noticeable also is that no participant cited “tariff levels” or “connection charges” as being a key success factor or obstacle in developing or maintaining PPPs although “rate of tariff increase” did figure strongly.

Beyond these generalized conclusions, participants identified and/or explored seven priority areas for broadening the use of PPPs in the water and sanitation sectors.

## Emerging Priorities in PPPs for Water

### 1. Incorporating institutional capacity building into PPP arrangements to improve public water services infrastructure

The trend for private sector investment in the development and rehabilitation of water infrastructure seems to be away from one-dimensional, long-term, high-risk contracts and investments towards more integrated solutions comprising the right mix of scale, investment profile and contract type. Greater use of medium-term (three- to twelve-year), lower-risk capital works and/or service and management contracts may offer alternatives. However, such arrangements need to incorporate explicit measures to ensure the long-term sustainability of water and sanitation provision beyond the shorter life of the contract.

In many regions where progress towards the Millennium Development Goals (MDGs) for water and sanitation is slow, the culture of performance within public utilities is also poor. Problem areas include the management of costs and revenues, policy delivery and responsiveness to customers. **Medium-term contracts with the private sector present an opportunity to incorporate into the terms of the contract performance regimes explicitly designed to strengthen the management capabilities of public utilities.** This might include capabilities in capital works procurement, production and network maintenance, billing and revenue collection, management of non-revenue water, IT and accounting, and improved procedures and management systems.

There are at least two distinct roles for development assistance in supporting this scenario. First, the use of output-based aid (sovereign or sub-sovereign lending) to ensure that public utilities outsource capital works and service delivery to private companies that also specialize in relevant human development and technical transfer. And second, the provision of risk finance (debt, equity, guarantees, etc.) to water companies or joint ventures, with performance for institutional strengthening covenanted in financing agreements.

### 2. Overcoming the high transaction costs of developing PPPs in water and sanitation

There has been a decline of interest by private (international) water companies in participating with development finance institutions and public utilities in water infrastructure projects in the developing world. This is in part a response to high transaction costs. Public utilities often lack the political autonomy to reach rapid decisions on the choice of the private sector partner or joint venture arrangement. Development finance institutions invariably have long and complicated financial planning and due diligence procedures. Negotiating with small-scale providers and the architects of community-based water and sanitation provision requires time and patience by all parties. Due to the higher risks of investing or operating in emerging markets, private water companies often elect to undertake more detailed feasibility studies and wider ranging risk analysis to inform their decision-making.

### Although public utilities frequently receive technical support from development assistance agencies in the form of transaction advisers and funds to support feasibility studies, the private sector has no such support.

In addition, few private companies wish to bear the start-up costs of initiating negotiations with public utilities and financiers, if, once a proposal is developed, it is put out to tender to those who have not shared in the early costs and risks. Part of the solution may lie in development finance institutions making convertible grants available to the private sector (as full or matched funds), earmarked to cover the costs of protracted negotiations and feasibility studies. These grants can then be either paid back or converted into equity if negotiations are successful.

A further disincentive to the private sector arises where a multilateral development bank offers financial support to the public sector at some later stage in the transaction negotiations. Here the very act of a private entity having already unilaterally engaged in feasibility studies or negotiations with government can

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automatically exclude them from participating in the subsequent, and compulsory, process of competitive bidding.

In summary, high transaction costs and competition rules can disincentivize the private sector from being proactive in approaching developing country governments to develop infrastructure proposals. Prohibitive transaction costs are also a feature of negotiations to bring pro-poor water and sanitation technologies into mainstream capital works and service contracts. Here the role of partnership interlocutors or brokers, particularly at the municipal level, may be important. Good multi-party and cross-sector facilitation skills can reduce the cost and time involved in designing pro-poor technical and management solutions that are acceptable to government, business and water users.

A second workstream in the Financing for Development Initiative assesses more concretely the topic of transaction costs and feasibility studies for private investors working with multilateral development banks and aid agencies. Three separate roundtable discussions are being organized to examine risk mitigation tools to improve the climate for private investment in poor countries and to bring financial capacity building to scale.

### 3. Bringing economies of scale and customer responsiveness to small-scale water providers through PPP arrangements

In many low and low-middle income countries, rural and peri-urban areas are poorly serviced by reliable sources of potable water. Filling this void is often an informal, highly inefficient and high-priced pattern of private small-scale water vendors.

**While awaiting major capital investments in production capacity and network expansion, an interim measure is to improve the efficiency of this informal sector.** Options include:

- voluntary frameworks and operating principles to improve water quality, reliability and accountability of small-scale providers (SSPs);
- micro-finance facilities as an incentive for SSPs to participate in voluntary frameworks;
- commitments by municipal water utilities to assure supply access points to small-scale providers at reasonable cost; and

- development of associations of SSPs to spread good practices, strengthen negotiation and lobbying capabilities with municipal utility and regulators.

At present, statistics for measuring progress against the MDGs exclude consideration of vendor and truck providers (Goal 7, Target 10, Indicator 30, Code 248). Reform in the informal sector could perhaps be designed in part to meet the thresholds for “improved water supply” so that small-scale providers can make an official contribution to the MDGs.

For greater reliability, quality and economies of scale to be realized, public utilities should incorporate in their capital investment plans a provision for SSP participation. Specific strategies should be developed for challenging dysfunctional monopolies (e.g., in truck providers), providing a degree of legitimacy to SSPs, establishing units dedicated to the management of SSPs, and possibly outsourcing sub-networks. Development assistance agencies can help by supporting SSP-friendly policy reform, funding surveys of SSP impact in order to identify opportunities for greater efficiencies, legitimacy and accountability, providing financial support to SSPs (either micro-finance via NGOs, or risk capital via SME finance facilities), and bolting SSP enhancement schemes into sectoral budget support or through covenants to financing arrangements with water companies.

### 4. Integrating appropriate, pro-poor, technologies into urban capital works and service contracts through PPP arrangements

Public criticism of private sector participation in water infrastructure rehabilitation and expansion is common. A frequent charge is that in order for private companies to secure a viable financial return on their investment, networks are not extended to the poorest. The private sector and public utilities argue that connections are not always possible because squatters living within the core urban area lack land title, and because peri-urban settlements are characterized by a disorganized layout prohibitive to efficient engineering solutions and economies of scale. However, there are many examples of NGOs, small and medium-sized private companies and municipal utilities that, using appropriate

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technology, have found cost-effective ways to connect very low-income customers to the main network. Technologies include metered standpipes, community constructed “last-mile” infrastructure, low-cost household connections, and community-managed revenue collection and maintenance. **New types of PPP arrangements need to be considered as a means to integrate pro-poor technologies within more conventional private sector urban capital works and service contracts.**

Key success factors in these new “bolt-on” arrangements are likely to include:

- the ability of NGOs, community representatives, public utilities and private water companies to negotiate and reach agreement on the most suitable technologies, be these ‘off-the shelf’ or adapted;
- finding technical and contractual solutions to integrating pro-poor technologies into contracts that do not undermine the financial viability of the core investment (hence “bolt-on” rather than “bolt-in” or “free-standing”);
- integrating community-managed maintenance, billing and revenue collection services with those of public utilities; and
- establishing effective oversight mechanisms acceptable to all parties.

### 5. Improving the efficiency of the rural groundwater “borehole” industry through PPP arrangements

Dispersed rural settlements in many low and low-middle income countries are dependent for drinking water on surface waters: ponds, dug-outs, springs, streams and rain-water harvesting. But these sources can carry an increasing risk of contamination and are frequently host to water-borne disease. Groundwater abstraction, in particular the borehole industry, offers one particular alternative.

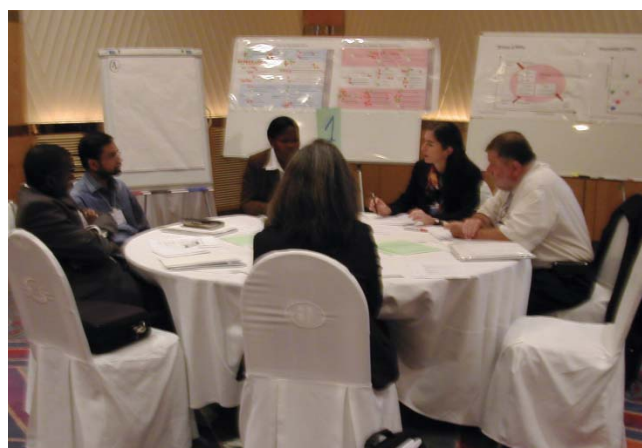
The rural borehole industry is often unregulated and inefficient, both in economic and environmental terms. Reform is needed. In order to address the industry’s image problem and become a force for responsible groundwater abstraction and water management, associations of borehole contractors and industry suppliers might be promoted. Associations would foster common standards and codes of conduct tailored to rural settings; provide a platform for the development and dissemination of best practice skills and technology (e.g., smaller rigs); and offer an interface with government and aid agencies. Further, municipal water authorities, environmental regulators and technically competent NGOs need to work with the private

borehole industry to find pro-poor, low-cost and low environmental-impact solutions. Lastly, meeting the needs of rural dwellers for reliable and accessible potable water through ground water abstraction will require substantial investments in the borehole industry.

**Development finance institutions could do more to provide financial support to rural borehole companies**, either directly through the targeting of SME financing facilities, or indirectly through local financial intermediaries, with covenants agreed on performance for access, quality and environmental sustainability.

### 6. Extending operational water supply and sanitation infrastructure used in manufacturing and mineral extraction to poor communities through PPP arrangements

Where existing water and sanitation infrastructure is insufficient, many companies install their own schemes. These are often for exclusive use by the factory, facility, plant or labour camp. In the medium term, companies need to secure and sustain a “social licence to operate” with local communities. They also need to position themselves in the longer term as the company of choice with governments. Many companies are thus looking for ways to extend their visible positive social and economic impact on society. Community investment programmes, along with training, employment and local business support schemes, are common ways in which companies seek to extend local benefits, often through PPPs. **Less tested is the role of PPPs in aligning the operational water supply and sanitation infrastructure of manufacturing plants and mining facilities with the infrastructure plans and budgets of district and regional government authorities.**



*Breakout group at the Roundtable discussions, Durban, South Africa, October 2004*

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For this approach to be successful a range of interests will need satisfying. This includes:

- the interests of the company for timely completion of capital works and reliable water supplies;
- those of community water users for levels of water quality higher than that needed for industrial purposes; and
- those of public utilities and private (or NGO) providers for control over sub-networks.

Development assistance and finance agencies might play a number of catalytic roles here:

- convening discussions and facilitating negotiations between the main parties;
- covering the transaction costs and feasibility studies for the parties;
- underwriting the risks to the private sector; and
- incentivizing local government through matched funding schemes.

## 7. Improving communication about private sector participation in water supply and sanitation through PPP arrangements

As noted, the roundtable on development-driven PPPs in water demonstrated the importance of political will and public support for water supply and sanitation schemes that involve the private sector. With water often being a politicized issue, and with high rates of tariff increase rightly or wrongly associated with private sector participation, better communication is needed to enable all parties to weigh up the merits of the many different options for private sector participation and PPPs, from constructing networks, to managing service provision or strengthening the capacity of public utilities.

One platform for improved communication is the trend for convening multistakeholder conferences, meetings, working groups and roundtable discussions. However, fatigue for this type of event has set in. This begs the following question:

**compared to the alternatives, to what extent are multistakeholder events successful in communicating to politicians and the public the realities of private sector participation and PPPs in water?** Should these events perhaps be handled differently?

## Looking Across the Roundtables

The first set of multistakeholder roundtable discussions on development-driven PPPs in water, health and education is now complete. One of the common themes to emerge is the need for greater communication between all parties, not least on the precise role of the private sector, and greater planning and coordination of public, private and civil society efforts.

Nearly three-quarters of the sector-specific indicators for measuring progress on the MDGs focus on either health, education or water<sup>1</sup>. Coincidentally, it is precisely these sectors in which participation of the private sector is often politically contentious. While PPPs in the less politicized sectors of power, transport and telecommunications can more easily utilize conventional mechanisms (principal-agent contracts, risk transfer, long-term agreements and support from mainstream financial institutions), the nature of the water, education and health sectors suggests that a broader multistakeholder approach and a shift towards more innovative PPP arrangements will be necessary to achieve a scaled response. **Providing water and sanitation, healthcare and basic education requires the simultaneous achievement of multiple development goals, viable financial returns, stronger institutions to ensure the sustainability of development outcomes, and broad political and public support. This requires more of a multi-sector approach, involving public and private service providers, user communities, project financiers, philanthropic corporations, regulators and international donors working together.** At a minimum, the roundtables suggest a need for improved dialogue and planning among these parties around policy options and regulatory reform. There is also significant interest in greater multi-sector collaboration in detailed project design, infrastructure development, service delivery, institutional strengthening and performance oversight.

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<sup>1</sup> OECD, UN, IMF and World Bank use the same 48 indicators for progress on MDGs. Excluding 15 indicators for Goal 8 - Global Partnership for Development (i.e., aid, markets and trade) leaves 33. Of these, 22 indicators (73%) are related to health, education or water.

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This overview has been compiled from information gathered during the roundtable in Durban. Prepared by the event facilitators, its purpose is to provide both a summary of the main topics covered in the roundtables and insight into new directions and outstanding issues. This overview will be used to inform a second set of roundtables in April/May 2005. The final report will follow.

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