Private Sector Participation in Water Infrastructure: OECD checklist for public action

Istanbul Version

Miguel Solanes, IISD Consultant

December 2009

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1.0 Background

OECD released the final version of its *Checklist for Private Sector Participation in Water Infrastructure* at the V World Water Forum in Istanbul, March 2009. Previous versions of the checklist were commented upon by the consultant in a report produced in August 2008. Neither of them adequately addressed the challenges and experiences resulting from private provision of water and sanitation in developing countries. A main concern was the scant treatment of the risks that the present system of international investment arbitration poses for developing countries. Other concerns were the incomplete treatment of the structural and regulatory issues raised by water and sanitation issues.

Past reports are annexed to this document.

2.0 The Istanbul Version

The Istanbul version of the checklist has, to some extent, answered some of the concerns raised by the previous reports of the consultant, yet a few questions remain.

2.1 Positive developments in the Istanbul version

- The request that private actors participate in good faith, due diligence, with commitment, promoting integrity, fighting corruption, taking responsibility for social consequences (Principles 6, 14, 20, 21, 22, 23, 24). Generally, encouraging responsible business conduct;
- A treatment of international arbitration that is more detailed than previous versions (Principle 15, Considerations for Governments);
- A warning that bilateral investment treaties allow foreign investors to have access to international arbitration (through the International Centre for Settlement of Investment Disputes [ICSID], for instance), even though the contract may provide for local courts jurisdiction (Principle 15, Considerations for Governments);
- Acknowledging the importance of economies of scale (Principle 2, Considerations for Governments; Principle 3, Considerations for Governments; Principle 7, Sector-Specific Features; Principle 10, Sector-Specific Features, Considerations for Governments);
- The recognition that the water sector is vulnerable to capture by vested interests and the risks of private sector participation, including capture by private operator (Principle 17, Considerations for Governments; Principle 21, Sector Specific Features, Introduction, Para 1; OECD, 2009, p. 20);

- The warning that the checklist does not intend to provide detailed technical advice, and the reference to other documents better suited to this task, such as the Policy Principles and Implementation Guidelines for Public-Private Partnerships for Water Supply and Sanitation (developed by the Swiss co-operation and implemented by Building Partnerships for Development) (OECD, 2009, p. 11);
- Pointing out to governments that companies are shying away from investment risks (OECD, 2009, pp. 7, 9, 15);
- Stressing the importance of sustainability analysis (Principles 1, 2, 24; OECD, 2009, pp. 34, 39);
- Pointing out that competition for the market can be circumvented through renegotiations and shareholding arrangements (OECD, 2009, pp. 24, 50);
- Acknowledging that small scale systems do not attract investors due to transaction costs and lack of credit worthiness (OECD, 2009, p. 52);
- Acknowledging that public guarantees have an impact on public finances and create contingent liabilities (OECD, 2009, pp. 19, 23, 34, 44, 45);
- Endorsing commonly agreed-upon principles and standards for responsible business conduct (Principle 20; OECD, 2009, p. 8, 34, 36);
- Recognizing that relevant entry fees and rate of return regulation reduce the opportunities for renegotiation (OECD, 2009, pp. 25, 32, 73 note quoting Guasch in Box 1.3);
- Pointing out that asymmetries of information increase the risk of government capture by specific interests:
- Acknowledging that many concessions failed to invest the amount of private funding they had originally committed, and did not meet their original contractual targets for coverage (OECD, 2009, pp. 7, 9, 15).

2.2 The hang-ups of the Istanbul version

- The checklist is a general report with a broad coverage of issues and topics. While it may be useful in showing a range of topics in the water supply and sanitation sectors, it is of limited use for practitioners confronting practical policy and operational choices.
- The checklist does not provide any guidance regarding the relative importance of the different subjects it addresses; as a result, in a field riddled with legal issues, it provides very limited guidance on the actual contents of regulations and contracts.
- There are tensions between the technical contents of the report and a number of political messages. For example, it acknowledges the importance of optimizing economies of scale and scope. Consequently, it points out that small water supply and sanitation systems are plagued by transaction costs and lack of credit worthiness. However, at the same time, it

indicates that efficiency has been a driver behind devolution of authority to local authorities (OECD, 2009, p. 28). There is a contradiction in the diverging messages sent to countries. If there are important economies of scale and scope, unqualified decentralization is not the best road to efficiency, particularly if the checklist also acknowledges that the sub-sovereign level is affected by financial and capacity constraints. There seems to be a lack of coherence in the treatment of the subject, and some disregard for country experiences and lessons, as well as for the industrial structure of the sector.

- Other parts of the checklist are simply contradictory. Thus, water and sanitation is at the same time capital and labour intensive, depending on the part of the report that is being read (OECD, 2009, pp. 20, 54). Professional literature emphasizes that the industry is capital intensive.
- The Istanbul checklist has improved over past versions regarding the treatment of international investment agreements. But even the present version runs short of highlighting the risks posed to countries. The discussion is almost perfunctory and presents the system in the best possible light. It does not elaborate on the gaps between commonly accepted national regulatory practices, police power, economic crisis and the decisions of investment arbitration. It affirms that contractual differences are outside the scope of international arbitration (OECD, 2009, p. 23), ignoring that expansive interpretation and umbrella clauses have resulted in contractual differences being judged by arbitrators. And it also ignores the bias risk resulting from the sole investor's initiative for arbitration to take place, the conflicts of interests arising from arbitrators who are also litigators, and the lack of systems of appeals and unification of jurisprudence. An additional problem of the system of investment arbitration, which the checklist does not analyze, is that decentralization and stakeholder participation and representation become almost meaningless in the context of international investment arbitration. Investment arbitration is overly centralized and does not need to take into account stakeholders' views. It takes the place of national jurisdiction and each arbitration tribunal is sovereign with regard to the case it is considering at any given time.
- The report mentions some of the risks faced by countries. It references information asymmetries and capture but omits a systemic treatment of other risks. Risks, in the checklist, seem to mostly affect the private sector, and have been systematized as such. But a number of important risks faced by countries are ignored, including: the disregard that international arbitration has for public interest issues, the imbalance created by expansive interpretations of investor's protection principles, the uncertainty regarding legal principles resulting from lack of unified jurisprudence and appeals systems, the problem of aggressive and strategic biddings, the moral hazard elements in investment protection principles, the free ride opportunities that investment protection affords foreign investors, the fact that investment arbitrators are willing to treat contract breaches as violations of investors rights - with or without umbrella clauses - and the national liability arising out of contracts with sub-

sovereign units.

- The checklist does not make a strong case for the need for national (as compared to other levels of government) regulation, which arises out of the national liability resulting from sub-sovereign obligations. National regulation improves the chances of countries to elaborate and enforce a coherent set of duties regarding the obligations of providers, foreign and national. Peru has recently enacted national regulations extending to all providers within the national territory. Providers have a duty of economic efficiency, transparency, due diligence and good faith. Their costs have to be competitive and their operational expenses reasonable. They have a duty to provide information, to provide prudent and reasonable management and to respect the rules of art and the regulations concerning technical, administrative and financial management. The duty of good faith extends to the preparation, submission and execution of contracts. Their investments must be used and useful.[1]
- The report is bent on proving that the private sector is relevant for developing countries. To illustrate the point, it includes informal vendors in the private sector (OECD, 2009, pp. 9, 14, 15, 28). It may be right in considering them private sector, but their inclusion seems to convey the message that some supply and sanitation problems are already addressed, when in fact there are stop-gap measures whose permanency may only perpetuate existing shortcomings.
- The checklist ignores the cornerstone of regulation, which is the duty of efficiency. Its omission is not mitigated by reference to other OECD publications. Although the word *efficiency* is a conspicuous part of the report, it is not suggested as a crucial duty of providers. The checklist assumes that private participation, per se, improves efficiency. Regulators familiar with price transfer practices, inflated operational costs and undue debt burdens will surely contest these rosy assumptions. Companies can profit by transferring inefficiencies to the public. This is why, in serious regulatory systems, efficiency is a legal duty of the regulator.
- The checklist perpetuates a common misconception: several paragraphs present equity and efficiency as different and potentially conflictive goals. In fact, it is only through efficiency that equity can be reached (OECD, 2009, pp. 10, 40). Lower costs per output facilitate the expansion of services; equity is an outcome of efficiency, and not a separate or different goal.
- The checklist ignores some of the most crucial regulatory problems faced by privatizing governments. In addition to efficiency problems and duties, it omits the consideration of prohibitions against transfer prices, and sanctions and penalties for their violation. It also omits the legal duty to transfer efficiency gains to the users.

[1] Peru, Res No 056-2008, SUNASS, Lima Peru, August 6 2008, El Peruano, Diario Oficial del Perú, p.377633, General Guideliness III.

- The checklist insists that rate of return regulation has higher information requirements than price cap regulation and that it leads to overinvestment (OECD, 2009, p. 25, Box 1.3). In so doing, it repeats commonly accepted theory, but empirical research proves that information requirements are the same for both rate of return and price cap, since the process of defining the potential for rate reduction has blurred the distinction between this method and the rate of return method. Consequently, the latter has sneaked in "through the back door." In addition, Rawls and Rees (1995) argue that the evidence for overinvestment is scant. One of the remarkable features about the literature criticizing rate of return regulation is the relative dearth of empirical work providing evidence that the theoretical deficiencies actually occur in practice. Still, less attention has been paid to the question of whether the alleged defects are inherent products of the form of regulation employed or result from the political context in which all regulatory systems have to operate.
- The checklist suggests that marginal, non-served areas may be served if they are left open to free entrance of providers. Ofwat, the UK water regulator, has recently announced that its efforts to promote competition in the sector were fruitless.[2]
- The checklist does not analyze the problems posed by contract regulation or the need for a hierarchical relationship between regulations and contracts. It is difficult to explain this omission, considering that it is a well-known problem. With concessions, governments could, for instance, argue that they were not selling the assets of the country and hence bypass legal or constitutional constraints and reduce the criticisms of reforms by anti-privatization segments of civil society. These concession contracts became the main regulatory instrument (Estache, Guasch & Trujillo, 2003). Unfortunately, there are major practical problems with this approach in the water supply and sanitation industry as well as in most other public utility sectors. Franchising is prone to a number of difficulties in some circumstances, and unfortunately the industries where regulatory problems are greatest are especially prone to such problems (Kay & Vickers, 1988).
- The checklist notes that comprehensive regulation may be costly (OECD, 2009, p. 71), without mentioning the costs of bad regulation, as World Bank publications have analyzed. One example is afforded by a study of the macroeconomic and distributional impacts of the privatization of public utilities in Argentina. Chisari, Estache and Romero (1997) found that the gains from efficient regulation are non-trivial. The gains from the private operation of utilities are about US$2.3 billion or 0.9 per cent of GDP. Effective regulation can save the economy an extra US$0.9 billion or 0.35 per cent of GDP. They conclude that ineffective regulation is equivalent to a 16 per cent implicit tax on the average consumer paid directly to the owner of the utilities' assets. How serious governments are about the fair distribution of gains of reform is revealed by how serious they are about regulation.

[2] http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/prs_pn1308_openmktcomp

- The checklist suggests that unbundling is not present in the water industry, which is a known technical and economic fact (OECD, 2009, p. 24). It suggests that it is different in the electricity sector, where the activities of generation, transmission and distribution have been segmented. In so doing, it ignores that there is a re-integration process going on even in the electricity sector.[3]
- The checklist notes that there are some limited opportunities for market competition in the sector. However, authorities argue that competition for the market is part of contestable markets. They comment that the theory of contestable markets is often strongly criticized because of its unrealistic assumptions about costless entry and exit, because it assumes an unnatural sequence of events when entry occurs and because it ignores the entrenched dominant position of the incumbent utilities. Implausible assumptions have been applied on an abstract plane to reach not only *insights*, but also emphatic conclusions and wide policy lessons. The system hangs in the air, lacking a foundation or even plausibility. If the adjacent technical analysis of multiproduct conditions were less formidable and the authors less famous, these ideas and claims would seem naive and premature. Their analysis only treats a specialized, extreme set of conditions, which are probably found in no real markets which have significant market power. Moreover the model rests on assumptions which are contradictory and which reverse reality (Shepherd, 1984). The theory has gained considerable currency, as an abstract construction. Yet, its impact on regulatory policy in relation to natural monopolies has been much less significant, simply because the assumptions of perfect contestability' on which it is based, notably that the entrant can costlessly leave the market when it is no longer profitable to remain, are rarely encountered in practice (Ogus, 1994).
- The checklist assumes that the sector has always been riddled with tensions, and that private participation has brought them to light (OECD, 2009, p. 10). The assertion may be right, but the problems posed by wrong designs, opportunistic bidding, unfulfilled promises,

[3] "Cristophe Defeuilley stressed that fifteen years after the reform the participation of existing domestic providers in intranational markets has not been reduced in any significant manner. The commercial model of vertical integration is still the most competitive, and providers have consolidated market shares through acquisitions in foreign countries. He also added that, similar to the US, electricity companies carrying out de-regulated activities, Europe had a 'speculative bauble.' The market capitalisation of the main companies took off in spite of their high level of indebtedness due to very optimistic expectations of future profits. A series of events put an end to this phase of expansion The decrease of wholesale prices, produced by over-investment in generation, endangered many independent generators. The practices of some companies discredited energy trading and put into question the credibility of company financial statements. Consequently, investors and the credit rating agencies became more risk averse, demanding that the companies reduced their indebtedness. The exit of most of the new entrants, the difficulties encountered by the experiments with new business models at the end of the 1990s strengthened the relevance and the efficiency of the ruling business model: vertical integration, with a balance between regulated and unregulated activities. Vertical integration found new virtues with the opening of the industry to competition. It allows the utilities to hedge against the risks of price fluctuation while reducing the volume of electricity that they are committed to buy or to sell on the wholesale markets or through long-term contracts" (ECLAC, 2005, p. 12).

government capture and the monopolistic behaviour of private firms have their own entity, which can not be ignored.

- The report has several references to arbitration of regulatory conflicts, which is partially credited for the success of the Chilean system (OECD, 2009, p. 27). Not all Chilean authorities are very enthusiastic about arbitration. Only one of the experts that sits at arbitration is independent. Despite the excellent work of the regulator, the differences between rates suggested by the regulator, and rates approved by the Commission may be too large, favouring the provider. Thus, in Chile, the Commission of Experts replaces the Regulator (Alfaro Fernandois, 2008, pp. 69-70).
- It would have been important to elaborate on the impact of general context, including macroeconomic conditions - and corruption levels - on the development and availability of water and sanitation services.
- The report seems to assign the same entity and importance to theories and concrete, proven experiences.
- The references that it makes to private sector in the water sector group together regular water providers, mining companies and construction and land development companies (OECD, 2009, pp. 7, 14, 16). The report ignores that different members of this heterogeneous group have different impacts on the water resource and on the service. It does not analyze possible conflicts of interests and market manipulation by different actors. This is why some countries require single-purpose companies (Chile) to qualify for a license in water services.
- Future work may consider the regulatory issues posed by non-investment contracts, such as management, affermage and service contracts, according to the experiences of countries familiar with the non-investment contract system (France).
- The report asserts that water supply and sanitation is local by nature companies (OECD, 2009, pp. 26, 57), but does not pay enough attention to the possibility of changing - and to the national experiences that have changed - the structure of the industry for the sake of efficiency, such as in Chile. This uncritical acceptance of a theoretical "local" nature of water services and water management ignores the nature of water as a resource, and the transaction costs, inefficiencies and lack of pro-activity of non-national water programs.
- Along the same lines, the checklist suggests that regulation of decentralized utilities should be local companies (OECD, 2009, p. 71). It acknowledges that there is a serious debt in local regulatory capacity, and it does not consider that when provision and regulation are at same level of government, the risks of capture increase. The World Bank Toolkit for Private Sector Participation in Water and Sanitation have stressed that the lower the level of regulatory bodies the higher the possibilities of capture by local interests and political forces.[4]

[4] World Bank (1997) *Toolkits for private sector participation in water and sanitation.* Contact: Fax: (202) 522-1500 E-mail: pic@worldbank.org

This is why advanced regulatory systems place regulatory bodies at either national level (England, Chile, Scotland, United States) or at state level (United States). But they never place regulatory authority at municipal level.

3.0 Conclusions

The Istanbul version of the checklist has improved on the contents of previous versions. However, its operational value is limited. The checklist does not fully discuss some of the most critical issues associated with private provision of water and sanitation services. Paramount among these limitations are:

- the treatment of international investment agreements and investment arbitration and their impacts on public interest issues, equity and efficiency;
- the scant attention paid to the trade-offs between contract and legal regulation, and the emphasis on contracts as the cornerstone of the relationship between governments and providers, without enough treatment of the limitations of contract regulation, and the need for supervening and overriding national regulation; and
- the lack of suggestions concerning the necessary inclusion of essential regulatory principles, both in regulations and contracts (i.e., efficiency, good faith, due diligence).

In addition, the checklist has some built-in elements of contradiction. Thus, decentralization and devolution to local level is at the same time efficient and a sacrifice of scale and scope economies, and local governments are incapable of regulation but should be given regulatory powers.

Above all, the checklist has uncritically repeated many of the arguments of the 1980s and 1990s without a due review of critical literature. This is particularly clear in the consideration of decentralization, price cap regulation and rate of return regulation.

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