Who will Win the Race to Privatise Water Utilities?

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Introduction

Changes in the way we conduct business during the past few years give new meaning to the phrase "change is the norm". All kinds of industries are modifying their structures and ways of doing business in response to new technology. But technology is not the only driver for change. Some industries are also being driven by the goals of improvements in efficiency and services while reducing negative impacts on our physical environment. The deregulation of the telecommunications and electric power industries has led to increased private sector involvement in competitive structures which result in better and less expensive services. An increased level of private sector involvement is expected to lead to similar changes in the water utility industry.

Participants in the change of the water utility industry are traditional water utility companies, "multi-utility" companies and service and equipment suppliers with the goal of owning and operating water utilities in new markets. These companies and applicable government agencies are driving different forms of private sector participation in the water utilities.

While these companies are drivers for change in the industry, they too are subject to external forces which require that they think about their structure. In the past few months several of these firms were subject to industry consolidation. This is evident in Vivendi's acquisition of US Filter and Enron's creation of Azurix and their acquisition of several substantially sized water companies in Europe, Latin America and North America. With this kind of consolidation, questions rise about the ability of smaller firms to compete effectively in the privatisation of the water industry. This question is best answered after looking at the models for private sector participation in the water utilities, the areas of opportunity and barriers to entry.

Why Privatise?

Operational efficiencies and the need for new sources of capital are the two primary reasons for creating public/private partnerships or privatising water utilities. Operational efficiencies stem from the lack of a profit motive in the public sector and the fact that few public water companies are willing or able to charge market prices for their goods and services. Shrinking government budgets, high replacement and maintenance requirements, increasing demand and urban growth and more stringent regulatory requirements all contribute to the need for improved efficiency and new investment.

Models for Private Sector Participation

The options for private sector participation can be ranged along a spectrum. At one end of the spectrum are those in which the government retains full responsibility for operations, maintenance, capital investment, financing and commercial risk. At the other end of the spectrum are those in which the private sector takes on much of this responsibility. The options are mainly distinguished by how they allocate responsibility for asset ownership, management and capital investment between the public and private spheres.

Management Contracts

Management contracts represent a good first step. Management contracts are a relatively simple way for the private sector to gain control of a water utility without exposing themselves to the risk of large-scale capital investments. Contracts generally cover the operation and maintenance of government-owned water utilities and usually run from three to five years. The simplest involve paying a private firm a fixed fee for performing managerial tasks. Because management contracts leave the majority of responsibility to governments for investment, they

are a good way for the private sector to test the waters without committing great sums of money to a particular utility. Management contracts are also beneficial in that they place most of the commercial risk in the government's hands.

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Management contracts are also useful where tariffs are still too low to support a full-scale concession. Management contracts are also of benefit where the legal, institutional and regulatory system is still developing and does not have a clear role for more extensive private sector involvement. Finally, management contracts are useful where it is difficult for citizens and leaders to come to consensus on the long-term role of the private sector in the sector. Management contracts are short in duration and involve no extensive long-term changes in the public sector or ownership.

Leases

Under a lease, a private firm buys the rights to an income stream from the utility's operations and assumes much of the commercial risk of those operations. The advantage of leases, like management contracts, is that the responsibility for capital investments lies with the government. Leases are appropriate where there is scope for large efficiency gains, but limited need for new investment.

Concessions

A concession gives the private partner responsibility

not only for the operation and maintenance of a utility's assets, but also for investments. Asset ownership remains with the government and full rights to those assets – usually for a period of between 20 and 30 years – lie with the private party. Concessions are often bid by price. The advantage of concessions is that they are a familiar vehicle in the developing world. Another benefit is that the private operator has full control over the assets.

Build-Operate-Transfer (BOT) Contracts

BOT contracts resemble concessions but are usually reserved for greenfield projects. In a typical BOT project, a private firm might construct a new water treatment plant, operate it for a number of years, then transfer ownership and operations back to the public sector. In a take or pay contract, the government usually agrees to purchase water at a specified price over a period of time.

BOT contracts have been used widely around the world. The advantages are that the private party has complete control over the assets and their operations and can realise efficiencies in design construction as well as operations. BOT arrangements are also favourable because they often represent sufficiently large investments to justify the expense of the transacting process.

There are many possible variations on the BOT model including build-operate-own (BOO) arrangements, in which the assets remain indefinitely with the private partner, and design-build-operate (DBO) arrangements, in which the public and private sectors share responsibility for capital investments.

Private Sector Opportunities

Private sector ownership of utilities is not new in the US. However, private sector involvement in the water utilities in this country lags far behind that in the telecommunications, cable TV, power generation and distribution and natural gas transmission and distribution industries. Public acceptance of private ownership, new requirements for water standards and investment needs driven by new standards and growth are opening new opportunities for private sector companies to own and operate water utilities in the US. Public awareness of successful public/private partnerships, such as those in the communities of Atlanta, Indianapolis and Cranston (Rhode Island), makes it easier for other communities to follow suit.

Federal government agencies in the US are looking at ways to involve the private sector in the more heavily subsidised water utilities. This process is complicated by the long-term subsidies provided to establish and maintain these water services and end-user opposition or inability to absorb their full cost.

The fastest growth for water privatisation seems to be taking place on the international front. The best known privatisation is probably that of Aguas Argentinas. A multinational consortium led by CGE is now five years into a 30-year contract designed to serve the residents of Buenos Aires. Two consortiums were recently awarded contracts to run the metropolitan waterworks and sewerage system in Manila, the Philippines. The other major project under way is in Izmit, Turkey.

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Challenges

The challenges faced by those who want to participate in the privatisation of the water sector are different from those of firms which now participate in operating water utilities in a 'home' market. There are obvious differences in how water services are provided in different regions and these need to be factored into the investment decisions of the 'privatisation' players. As companies primarily used to making operational decisions enter the privatisation race, they will need to think about:

1. the long-term viability of the privatising company;

2. the political risks associated with operating outside their own turf (even in different states or regions of the same country); and

3. currency risks associated with investments in foreign countries.

It is also important to consider the timeframe in which regulators will make decisions.

Creating Sustainable Structures

Given the magnitude of water demand and investment, the increasing visibility and proven capacity to structure project finance transactions, and privatisations for other utility segments, the water sector has been slow to develop. While some impediments are unique to water, many of the same issues were mentioned 5–7 years ago as roadblocks to establishing the first power projects. Firstly, water projects have the disadvantage of being last in the queue. Governments consider the development of power, telecommunications and transportation more critical to economic development than water.

Second, water enterprises tend to be in the hands of sub-sovereign governments – municipalities, states and provinces. Many of these utilities are small and run by managers who are less familiar with concepts of project finance and/or privatisation than their central government counterparts. A further complication is the turnover of local government politicians.

The third potential impediment is the financial and operational condition of the off-take utility. The amount of unaccounted-for water is usually at a minimum of 40%.

Fourth, there is a widespread perception that water is an entitlement. As a public necessity, it is argued, water rates should be kept as low as possible. Political sensitivity to rate hikes and the pressure to keep water bills low must be effectively dealt with in the project structuring process.

Finally, tariff setting poses challenges. A rational, full-cost recovery tariff is not yet developed in most places.

Currency Risk

The international financial crises of 1997 and 1998 highlight the particular risk that foreign currency raises for infrastructure debt. Infrastructure projects have little or no ability to cover exposure since they generally lack the chief basis on which currency can be hedged – revenues denominated in hard currency. Currency pegs and reserves to cover devaluation can, at best, provide only limited protection.

Cross border investment in water utilities is challenged by the mismatch between the investors' desire to have a return based on the currency of the investment and the problems associated with changes in water tariffs that are linked to foreign currency changes rather than improvements in service and/or local inflation. There is no easy answer to this question. Each investor and government agency responsible for oversight of water tariffs will deal with this issue on a case-by-case basis. In some situations currency swaps or hedges can absorb the risk for a few years. The only real long-term protection for foreign investors are those situations where tariffs are adjusted with changes in foreign exchange. Otherwise, foreign investors are forced to look at long-term macroeconomic changes to correct short-term foreign exchange deviations from inflation trends.

Political Risk

Political risk remains one of the major reasons behind the high cost of debt in most emerging markets. Political risk is the willingness of governments to support arrangements on which project, utility and concession financings rest – from off-take pricing formulas to contract tariff and off-take arrangements.

Players

Each company participating in the water utility industry has its own reasons for doing so. There seem to be, however, several broad trends which motivate organisations to participate and different objectives which follow from these motives.

Traditional water utilities which participate in this industry either do so because they have an incentive to be an owner and/or operator in areas outside their 'home' territory or do so because they (or their

Table 1: Water Utility Projects/Investments of the Top Five Private Sponsors (by region, 1990–1997)

Company	Asia	Europe	LAC	MENA	SSAfrica	Total
Suez Lyonnaise des Eaux (France)	11	7	6	2	2	28
Vivendi (France)	4	3	3	0	3	13
Aguas de Barcelona (Spain)	0	0	6	6	0	6
Thames Water (England)	4	1	1	0	0	6
SAUR (France)	1	1	0	0	3	5

Source: World Bank, 1999.

regulators) expect to benefit from a change in ownership or long-term contractual relationship which transfers the risks and rewards of operation. French and English water utilities have longer histories as private sector entities and are much more active than their US counterparts in conducting their business outside their traditional territories. Although it is likely that the French and English water utilities will continue to dominate the industry as it becomes more and more global, we also expect that the trend towards privatisation in the US will drive more US companies to look at how they can compete in other regions of the US and outside the US.

Vendors (operators and suppliers of equipment, engineering and construction services) which traditionally work with the water utilities and have good international experience are logical partners for water utility companies which are looking to expend outside their traditional territory. These firms sometimes share in an investment during construction and early years of operation in situations which provide a significant level of 'core' business (engineering, construction and/or equipment supply).

Local and regional firms which have capabilities in the water utility industry and are well placed in their local political circles are likely to be sought out by some of the international firms which are looking to invest in their local water utility.

Private investment has been most prominent in the UK where the private sector owns 100% of the English and Welsh water companies. In France, this figure is about 85%. Vivendi and Lyonnaise des Eaux are the largest French companies. They are actively expanding their operations worldwide. United Water (a Bechtel subsidiary) and Azurix, a spin-off of Enron, have recently entered the international arena and are promising competition for their long-established European rivals.

The top five international private sponsors are listed in *Table 1*.

Requirements for Success

Local Support

The government's ability to raise tariffs is directly related to perception of the public's willingness to pay. It has been shown time and time again in developing countries that consumers are willing to pay for good service.

Thus, it is important for the private developer to mobilise community participation from the outset. Well-respected community members/community associations could be enlisted to educate the general public with respect to direct benefits which can be expected from project activities, the level of costs consumers should expect to incur and whether any social mechanisms exist to assist those in need with excessive financial burdens.

Sufficient Financial Resources

The main method to finance infrastructure investment is through project finance. More often than not, project finance is limited by the lack of available debt, not equity. For the most part, international private lending does not have the tenor required for long-term infrastructure projects and local financing is almost non-existent.

In most developing countries, the absence of long-term capital market instruments, the high cost of capital and insufficient liquidity in securities markets make raising local funds problematic. Long-term financing is especially difficult in markets that are relatively illiquid, and the public is only willing to make short-term commitments. Efforts are needed to support the creation of domestic sources of funding through the development of local bond and equity markets, the promotion of domestic institutional investors and the growth of ancillary market institutions.

Conclusion

There are several models by which the private sector can participate in the water services that are still run by government agencies. This variety is a reflection of the uniquely local and political nature of the water utility industry. As with telecoms and power industries, the participants in the race to create new competitive structures in the water utilities will use models which work for the opportunity at hand. Some aspects of completed transaction can be used in other locations and some may even be globally applicable. Other aspects of a transaction will be unique to the opportunity and may require local government involvement. Larger organisations, the '800-pound gorillas' with plenty of capital and experience, have the ability to position themselves early in new markets and create structures to suit their needs. Smaller 'niche' players will be most effective in the markets where they have the best technical and political capabilities. The winners will be determined on a case-by-case basis. In some cases, these will be the 800-pound gorillas and in others it will be the smaller (and perhaps by necessity more nimble) niche players. ■