

# Utility Provision: Contract Design in the Interest of the Poor

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## I. Introduction

Access to basic utility services such as water, electricity and sanitation are essential for meeting internationally agreed development goals. For many of the world's poorest people, however, these services remain unaffordable or unavailable. The losses in productivity and human potential are beyond measure. Inequitable access to basic services is not only a humanitarian crisis, but also a serious obstacle to development.

Current practice in utility provision, in which governments privatise service delivery either partially or entirely, is fraught with broken contracts, failed projects and stagnant access. A continued focus on cost recovery has brought a real human cost and threatens progress towards social inclusion.

Reforming public utilities is a worthy endeavour, especially to improve the performance of ailing state-run companies. In low-income countries, public provision is still paramount because social objectives—as opposed to efficiency gains—are worth considering. Even the developed countries started privatising their utilities only after they achieved 100 per cent access to safe water, for instance (Hailu, 2008). Where social objectives are met and efficiency gains are considered, the rights of consumers must be given legal recognition when privatisation contracts are designed. Only contracts designed in the interest of the poor can result in a dispute-free provision of services. This is the concern of this Policy Research Brief.

## II. The Need for Increased Access

Expanding water and sanitation services to poor households is in keeping with pledges made at the United Nations that the right to water is “indispensable for leading a life in human dignity” and “a prerequisite for the realisation of other human rights.” More than 1 billion people are denied the right to clean water and 2.6 billion people lack access to adequate sanitation. The ramifications are numerous: every year some 1.8 million children die as a result of diseases caused by unclean water and poor sanitation. Meeting the Millennium Development Goals (MDGs) for water and sanitation would prevent 470,000 deaths a year (UNDP, 2006).

A cost-benefit analysis undertaken by the World Health Organisation (WHO) found that halving the proportion of people without sustainable access to safe water and basic sanitation by 2015 would bring substantial economic gains: every US\$1 invested would yield an economic return of between US\$3 and US\$34, depending on the region. Greater access to water and sanitation improves health, which allows for greater productivity, as does access to electricity. The time savings associated with having water and sanitation facilities nearby help increase school attendance (WHO/UNICEF, 2004).

## III. Current Practice in Service Delivery: The Corporatisation Drive

Over the past 20 years there has been much debate about the most effective way to deliver utility services to the poor. The public sector's ability to deliver these services has been limited, in large part because of financial constraints, particularly if the country is highly indebted. The response to this shortcoming has been the widespread introduction of market-oriented solutions: service delivery by the private sector, including full-scale privatisation or corporatisation.

Corporatisation in the utility sector is a long-term contractual agreement between a public agency and a private company to secure funding for, build and maintain an infrastructure project, and to deliver utility services traditionally provided by the public sector. The stated aim of these public-private partnerships is to mobilise private capital when the magnitude of the investment



Photo by Brendan Bernard.

required is prohibitive for the public sector. Thus far, however, privatisation has failed to deliver adequate investments. There is a lack of economic incentives for private operators to invest in rural and low-income neighbourhoods, where they do not expect to recover costs. When a private firm does undertake a utility provision project, the focus on covering costs and financial sustainability leads in many cases to unaffordable rate increases for the poor. The cost-recovery measures and lack of investment run counter to social objectives (Dagdeviren and Haiul, 2008)

To improve public-private arrangements in the provision of utility services to the poor, the focus should be on the poor first. This approach to provision requires a *legal framework* that fully acknowledges the human right to water and sanitation. When contracting out or in corporatisation arrangements, ensuring access to basic services is the primary objective of contract design.

#### IV. A Legal Framework for the Poor

A legal framework that guarantees a minimum level of access for the poor must be the foundation of utility service provision. South Africa has embarked on one of the most ambitious water rights reform processes: the reform established the right of citizens to water with the Bill of Rights in 1996, the Water Services Act in 1997 and the National Water Act in 1998. The legal framework is designed to meet basic needs and also to address issues of social equality.

All South Africans have the right to enough water to meet their basic needs, but fulfilling these rights will take some time: early estimates of the timeframe for delivery of basic water services for all were between 7 and 25 years, depending on the availability of funding. After the lengthy but necessary process of public participation to develop the

new laws, water resources managers in South Africa have begun implementing the reform. Many changes have already taken place or are underway, including restructuring and realigning the national Department of Water Affairs and Forestry—all to support the new paradigm and the approach to integrated water resources management and improved rights (Bruns et al., 2005).

It will take time to change legal and regulatory institutions, as well as to redesign water governance for participation. But the establishment of access to water as a constitutional right must be the very foundation of the equitable provision of utility services. In countries where some social objectives are met and efficiency gains are considered, utility provision contracts must guarantee non-negotiable coverage of the poor.

#### V. Transparency, Participation and Dispute Prevention

Under contracting out and corporatisation, contract design must properly evaluate the extent and lack of services in the areas to be covered, as well as the services that are appropriate. For example, if the contracts stipulate that operating companies provide services in all areas using a fixed tariff, the operators will focus service provision on populations from which they will receive the highest returns on their investment. This approach leaves the poor behind. Equitable service provision is the result of differentiated tariffs at different income levels and in different areas. The Zambian electricity company ZESCO, for instance, uses a tiered tariff system for its services: those who consume up to 100 kilowatt hours pay less than those who consume up to 400. Those who consume less pay less per unit of consumption, a step towards making electricity more affordable for the poor.

To ensure that a proposed infrastructure project fits the needs of the community to be served, the bid/contract must be

Table

**Caseload of the International Centre for the Settlement of Investment Disputes**

Region	Sector	Pending	Closed
Latin America	Water/sanitation	8	5
Latin America	Gas	5	1
Latin America	Electricity	10	3
Latin America	Telecoms	1	
South Asia	Gas	1	
Central Asia	Electricity	4	
Central Asia	Gas	4	
Africa	Electricity	1	1
Africa	Water/sanitation	1	
Middle East	Water/sanitation	1	1

Source: International Centre for the Settlement of Investment Disputes, [www.worldbank.org/icsid](http://www.worldbank.org/icsid).

designed in consultation with that community. This provides crucial inputs on scope and priorities in the design of corporatisation or contracting out: what services people want, how much they are prepared to pay, and what improvements are necessary to meet immediate needs and what can wait. When the cost of services is more than the government deems reasonable, it may provide subsidies to cover the difference between the cost and the desired tariff, or simply provide the service itself. Analysis based on consultation and participation is necessary to determine the distribution of costs and benefits of corporatised services, and how they may be distributed equitably.

Participation by the poor will not be automatic; it must be sought. Participation is facilitated by first sharing and disseminating information about the proposed means of service provision. Once the community is made aware of the pending project through a capacity building exercise, consumers can discuss their service needs and financial constraints, and can air any concerns they may have.

If the members of the community to be served are not consulted and their participation in the project design and contracting process is weak, the endeavour may very well fail. If the design mostly serves the interests of the private company and/or the government rather than the community, it is fundamentally flawed. If the project runs into trouble when a dispute arises between any of the parties involved, the results can be disastrous.

The International Centre for the Settlement of Investment Disputes (ICSID) is currently arbitrating many contract disputes (see Table). In Latin America alone there are 10 pending disputes in the electricity sector, five in the gas sector, and eight in the water and sanitation sector. ICSID, which is linked to the World Bank, is an international arbitration institution devoted to the settlement of investor-state disputes. Its large caseload suggests that the focus must be on dispute prevention rather than arbitration. Disputes or project terminations can mean service disruptions or no service at all, leaving the poor where they started.

## VI. Cochabamba, Bolivia

In limited domestic markets, privatisation is replacing public monopolies with private monopolies whose high prices have a negative impact on the poor. Utility tariffs and connection fees inevitably increase under privatisation, in the interest of full cost recovery and as a guarantee to the new owners. In many cases, tariffs increased even before privatisation as part of restructuring. Water and electricity disputes can lead to civil unrest, such as that which occurred in Cochabamba, Bolivia.

In Cochabamba, after the 1999 concession for water services was signed, civil unrest prompted by exorbitant tariffs under the new service provision arrangements caused the government to cancel the contract. After closed-door

negotiations, the government had signed a contract with the sole bidder, Aguas del Tunari. The private firm was to undertake a huge, multipurpose project to provide not only water but also hydroelectric power and irrigation. Since Bolivia receives loans from the World Bank, the government faced certain constraints: in its *Bolivia Public Expenditure Review*, the World Bank stipulated that “no subsidies should be given to ameliorate the increase in water tariffs in Cochabamba, which should reflect the full cost of provision by the Misicuni multipurpose project” (World Bank, 1999, p. 6). In other words, users of water services in Latin America’s poorest country were expected to pay up-front the costs incurred by the project, making this arrangement emphatically anti-poor from the outset.

In October 1999, Aguas del Tunari officially announced that it had 40-year concession rights to water and sanitation service provision in Cochabamba. Concurrently, the Bolivian government passed the Drinking Water and Sanitation Law, allowing for privatisation of these services, which in effect made poor consumers responsible for bearing their full cost (PBS, 2002). Rather than give water rights to the poor, this legal framework gave cost recovery rights to private companies. Coupled with the stipulation that the government was not to provide subsidies, these circumstances virtually guaranteed that this public-private partnership would run counter to the interests of the poor.

As Aguas del Tunari launched the Misicuni project the company sharply increased water tariffs to cover costs, doubling or tripling consumers’ water expenses—which the company had assured the government it would only increase by 35 per cent. Massive protests ensued. Neither the government nor Aguas del Tunari took action to address the concerns of the demonstrators and thus the protests intensified. A four-month period of violence and resistance followed, and ended when the government agreed to withdraw Aguas del Tunari from the project, release detained protesters and repeal the Drinking Water and Sanitation Law in April 2000 (PBS, 2002).

The lessons to be drawn from the Cochabamba experience are many. In this case, the framework did not protect the welfare of the poor but rather the income of the private utilities. The bidding process was not transparent: there was only one bidder and the negotiations took place behind closed doors.

The advice the government received from international organisations did not allow the costly multipurpose project to be subsidised, forcing the Bolivian people to pay up-front for it. If poor consumers had been consulted about their needs and their ability to pay for services, the project could have been better suited to the community. There was no adequate mechanism for providing and responding to feedback, a circumstance that led to increasing frustration and an escalation of the protests.

## VII. The Way Forward

In order to prevent breach of contract or other disputes from arising, transparency and open participation are crucial. Open bidding processes to ensure proper competition, publication of contracts, media coverage and a voice for stakeholders are all necessary. No project design will please all stakeholders, but their support will be greater if they see the design process as legitimate. This legitimacy begins with the underlying legal framework: the right to water and priority for social objectives. The process specific to the arrangement must also be legitimate. The selection of a private operator must be fair and transparent.

For instance, in two concessions for the provision of water and sanitation services in Manila in 1997, much effort was made to assure the public that the process was transparent. Bids were opened in front of television cameras and the bidding results were featured in the headlines of the city's largest newspapers (World Bank, 2006).

If consumers understand the goals of corporatisation, have had a chance to express their needs and concerns, and have a say in the type of service and tariff, they are more likely to accept the outcome. Then, after the project is underway, there must still

be an open channel of communication for service recipients, especially the poorest, so as to ensure accountability. This will lessen the likelihood of disputes and project termination. A framework for this channel of communication can be included in the contract.

Since the interests of public and private sector actors will be protected by legal representation, it may be beneficial to have an independent agency working for the poor—as regards the transparency of the contract negotiations.

The participation of a neutral body, such as a United Nations agency, would provide greater transparency and increase confidence in the fairness of the contract among governments, private firms and the recipients of utility services. It would also guarantee that best practices from other infrastructure development projects are followed. Most importantly, it would ensure that contracts are signed in the interest of poor consumers. It is important to empower the poor so that they know their rights and obligations regarding the contract.

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