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Position Paper by the International Private Sector on its Role in the Reform of Water and Wastewater Utilities in Eastern Europe, Caucasus and Central Asia

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This paper has been prepared by Mr. Lloyd Martin of Severn Trent Water International with inputs that have been received following written consultations among international private sector stakeholders.

POSITION PAPER BY THE INTERNATIONAL PRIVATE SECTOR ON ITS ROLE IN THE REFORM OF WATER AND WASTEWATER UTILITIES IN EASTERN EUROPE, CAUCASUS AND CENTRAL ASIA

PUBLIC-PRIVATE PARTNERSHIPS IN THE WATER SECTOR OF THE EECCA REGION: UPDATE AND RECOMMENDATIONS FOR THE IMPROVEMENT OF SERVICE DELIVERY

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Executive summary

It is now widely recognised that achieving the water-related Millennium Development Goals will require not only significant reform within the water sector but also the mobilisation of significant inputs from private companies, both in terms of finance and know-how. However, Public-Private Partnerships (PPPs) in EECCA remain at a low level, both in terms of numbers and in terms of the level of involvement and responsibility being taken by the private sector. Currently there are about 10 PPP projects involving international partners in the EECCA region, most of which involve an international private company as an operator. Although the climate for PPP in the two most populated EECCA countries has recently improved, mainly due to the development of a strong domestic private sector (Russia) and a marked political swing to the West (Ukraine), this has yet to manifest itself in significant additional levels of international PPP.

Networked water supply and wastewater systems have extremely high capital costs, well in excess of other infrastructure services. These are mostly financed with debt, for as long term as is commercially available. Given the high initial costs, extremely long pay-back periods are necessary, and it is essential that revenue streams are as secure as possible. Urban water services are also a business with relatively low rates of return on investment. Due to these sectoral specificities, private operators are particularly sensitive to the quality of the investment climate and the level of risk, which is an important obstacle to PPP in many regions of the world. In EECCA countries, both the investment climate and the scale/predictability of revenue streams are usually at a low level.

This paper seeks to identify, from a private sector point of view, the key measures that EECCA governments, IFIs, donors and the private sector would need to undertake to overcome the barriers to PPP and scale-up private sector inputs to the reform of water supply and sanitation in the region. A few highlights are given below:

- Political commitment to PPP, at all relevant government levels, is key to their success. While this takes time, management contracts may be used as a first step in building trust on all sides, and leading to more ambitious forms of PPP at a later stage.
- The private sector will also look for strong, independent utility regulation as evidence of government commitment towards PPP. Currently, utilities often remain highly-politicised in the EECCA region.
- There is a need to establish realistic tariff levels that will enable full cost-recovery, with the elimination of cross-subsidies between industry and domestic customers. Central governments have a role to play in helping to overcome such blockages, which usually occur at the local level.
- Due to affordability constraints in EECCA households, it may also be necessary at present to consider 'hybrid' funding arrangements, where capital investment may be financed from public budgets, while customers' tariffs cover only operation and maintenance costs.
- Further assistance in the reform process can be provided if the public sector makes every effort to ensure transparent tendering of PPP projects. One of the reasons cited by the private sector for the lack of attractiveness of many EECCA markets has been widely-held concerns over tendering transparency.
- Although PPP contracts provide the private sector with rights, these rights cannot be enforced effectively if local authorities do not recognise them. IFIs and other donors could reduce country risk by providing guarantees that would compensate the private sector for any breaches of contract that arise under such circumstances.
- In many cases, ongoing PPP projects have suffered from a lack of reliable data upon which both the contract and PPP project are founded, leading to the need to reassess and adjust performance-based payments as the project has developed. The public sector should ensure whenever possible that such data is representative of the actual situation, and if this is not possible, it should accept the need to re-evaluate such data after the contract has begun.

Why are Water Sector policy makers interested in Public-Private Partnerships?

Improving the delivery of urban water and waste water services is a critical need for most developing countries and economies in transition. In OECD countries investment needs also will increase substantially over the next years requiring greater efficiency through better management and the use of new sources for investments. For instance, in the European Union about USD 75bn per year are currently spent, and capital investment is predicted to increase by 7% a year¹. The report of the Camdessus Group to the Third World Water Forum in Kyoto, 2003, suggests that in developing countries, current spending on water of USD 75bn a year needs to be increased to about USD 180bn if the Millennium Development Goals on water and sanitation are to be met². For the EECCA³ region, a report by the Government of Denmark identifies the annual finance needed for operation, maintenance, and investment at about EUR 7bn per year. However, this target will be difficult to meet with public funds alone as both government budgets and ODA will only provide limited funds. Governments are therefore increasingly looking to a range of private sector partners to provide access to two key resources: (1) improved water management systems and technical options, and (2) private investment funds to cover their burgeoning long-term capital needs.

What is PPP ?

Public-Private Partnerships refer to any form of agreement (partnership) between public and private parties established for the provision of urban and/or utility services. PPPs should not be misunderstood as privatisation (i.e. asset divestiture), where the ownership, as well as the management, of the water infrastructure is transferred, in whole or in part, to the private sector.

A wide range of approaches for involving the private sector in improving the performance of water and sanitation systems exists. Some options keep the operations (and ownership) in public hands, but involve the private sector in the design and construction of the infrastructure. Other options involve private actors in the management, operation and/or the financing of assets. Hence, they involve different degrees of private and public sector responsibilities for service delivery. There thus exists a spectrum of PPPs, and different levels can be appropriate for any given public-private situation (see Figure 1). In every case, however, a prime objective is to improve the performance of that service delivery.

In all of these options, however, a public authority remains responsible for overseeing the activity and for ultimately ensuring that public service needs are met. Governments (national or local) retain final responsibility for setting and enforcing performance standards. The fact that the water sector is one of local natural monopolies requires a strong regulatory role to ensure that performance standards are met and the interests of consumers protected.

¹ Owen, David Lloyd, (2002), *The European Water Industry – Market Drivers and Responses*, CWC Publishing, London

² World Panel on Financing Water Infrastructure (2003), *Financing Water for All*, Paris

³ EECCA stands for Eastern Europe, Caucasus and Central Asia. It comprises the following twelve countries: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

Figure 1: Allocation of Public/Private Responsibilities across Different Forms of Private Involvement in Water Services

	Setting Performance Standards	Asset Ownership	Capital Investment	Design & Build	Operation	User Fee Collection	Oversight of Performance and Fees
Fully Public Provision							
Passive Private Investment							
Design and Construct Contracts							
Service Contracts							
Joint Ventures							
Build, Operate, Transfer							
Concession Contracts							
Passive Public Investment							
Fully Private Provision							

Key: Dark grey = public responsibility
Light grey = shared public/private responsibility
White = private responsibility

Source: Yale-UNDP Partnerships Program 1998

Source: OECD, (2000), Global Trends in Urban Water Supply and Waste Water Financing and Management: Changing Roles for the Public and Private Sector, Paris

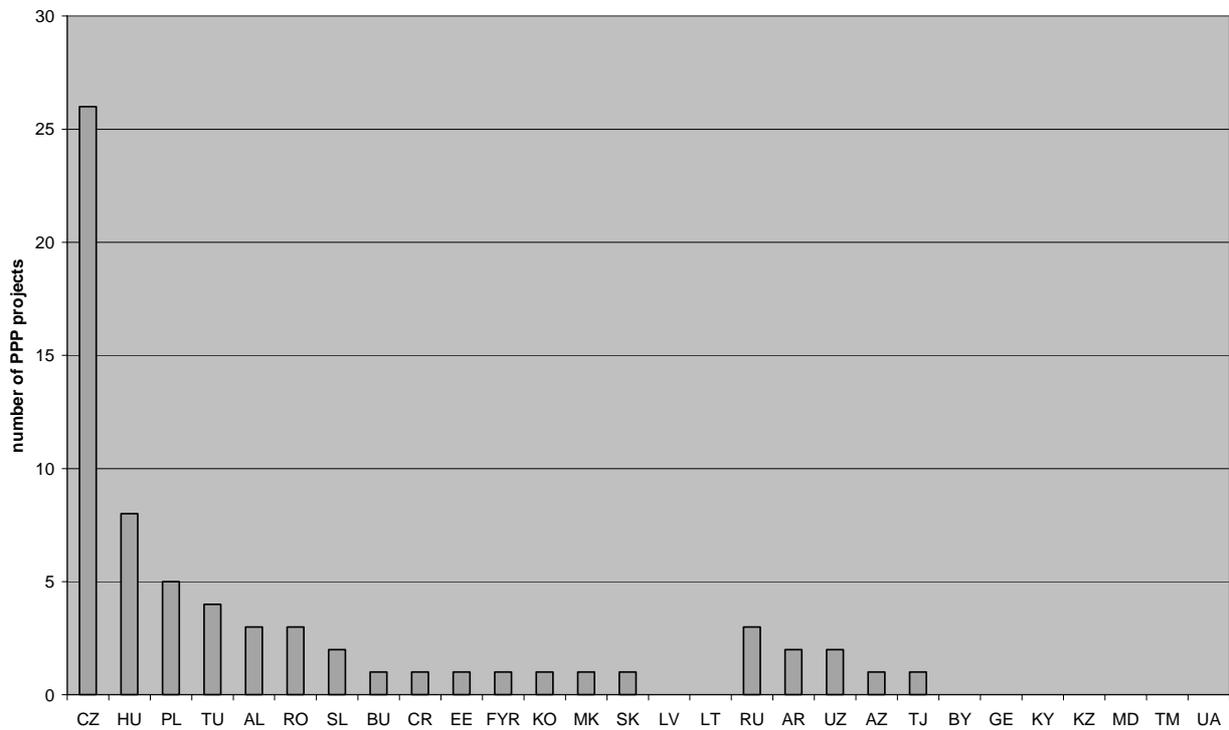
Current state of PPP in the EECCA water sector

Public-Private Partnerships in EECCA remain at a low level, both in terms of numbers as in terms of the level of involvement and responsibility taken by the private sector. Currently there are about 10 PPP projects involving international partners in the EECCA region, most of which involve an international private company as an operator. This constitutes roughly a doubling of the number of such projects since the time of the Almaty conference, five years ago (see Annex for a current list of major PPP projects in EECCA).

For comparison, in Central Europe, and in the Balkans, with a much smaller population than EECCA, about 58 Public Private Partnerships in the water supply and sanitation sector have been reported (see Figure 2).

A survey conducted in 2002, involving major private sector actors active in the EECCA and Central European regions, revealed that most EECCA countries received very low ratings in terms of their attractiveness for PPP (see Table 1). Russia, Kazakhstan and Ukraine, mainly due to their market size, were perceived as being more attractive than other EECCA countries, achieving similar ratings as countries in South-East Europe (e.g. Albania, Macedonia, FYR and Bosnia & Herzegovina).

Figure 2: Number of PPP projects involving international partners in Europe and Central Asia⁴



Source: OECD/World Bank (2003), Private Sector Participation in the Water Sector in the ECA Region: Emerging Lessons, www.oecd.org/env/water and EAP Task Force survey.

⁴ Europe and Central Asia (ECA) comprises: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia FYR, Poland, Romania, Slovak Republic, Slovenia, Serbia and Montenegro + EECCA countries + Turkey)

Reviewing the situation for the Almaty+5 Conference in 2005, an evolving situation emerges. In 2002, the subset of EECCA countries within the ECA region was located well towards the 'not attractive' end of the PPP-attractiveness spectrum, with all EECCA territories being classified as either Group 3 or Group 4. Now, in 2005, the climate for PPP in some EECCA countries has improved, with many private sector players considering the Russian Federation and Ukraine as being within Group 2, predominantly because of their market size (in both countries) plus the development of a strong local private sector (in the case of Russia)⁶ and the marked political swing towards the West (in the case of the Ukraine). At present, however, this increased attractiveness has yet to manifest itself in significant additional levels of international PPP in either country. There is, therefore a paradox: for despite the more attractive environment, there is probably a decline in the interest of the international private sector towards PPP in EECCA.

One consequence of the generally low attractiveness of the EECCA region and the lack of interest on the part of the international private sector is that the type of private sector involvement is usually less ambitious than elsewhere in ECA, or other regions. While in the Balkans and Central Europe, there is a prevalence of concession-, lease- and BOT-based contracts, most PPPs in EECCA have tended to be management contracts, where the private operator has a very limited responsibility as well as low levels of risk. The implication is that very little, if any private investment into the water sector has been generated in EECCA to date. Where the private sector is present in EECCA, its contribution to the reform of the water sector has mostly focused on the provision of technical and management know-how.

It should be noted that this overview has concentrated on the situation with PPP involving international participants. In the Russian Federation and Kazakhstan, many PPPs involving domestic private operators have been emerging of late. In the Russian Federation the local private sector claims to operate water systems in about 20 large cities representing approximately **11%** of the urban population. In Kazakhstan, nearly 40% of water utilities serving small and medium sized towns are privately operated. A separate paper discussing the situation in the Russian Federation has been developed as part of the Almaty+5 Conference documentation.

Reasons for EECCA's low attractiveness to, and the low interest of, the international private sector

Networked water supply and wastewater systems have extremely high capital costs, well in excess of other infrastructure services. These are mostly financed with debt, for as long term as is commercially available. Given the high initial costs, extremely long pay-back periods are necessary, and it is essential that revenue streams are as secure as possible. Urban water services are also a business with relatively low rates of return on investment. Due to these sectoral specificities, private operators are particularly sensitive to the quality of the investment climate and the level of risk, which is an important obstacle to PPP in many regions of the world. In EECCA countries, both the investment climate and the scale/predictability of revenue streams are usually at a low level.

The importance of the risk dimension has been gaining additional weight recently, due to the growing risk-aversion of most international operator/investors. This has been in part a reaction to sector-specific shocks such as the monetary crises in Argentina, South East Asia and Russia in the mid/late 1990s and their repercussions on USD revenues of water operators, and a more general rise in risk-aversion in international business, following September 11, 2001. One immediate reaction of international private operators in the EECCA water sector has been to favour management contracts rather than riskier options such as leases and concessions, and to focus their financing strategies on leveraging IFI and donor funds rather than tapping into equity or private financial markets.

⁶ The impact of the local Russian private sector is discussed in more detail below.

Operators have been demanding that donors and IFIs take over all risks not directly related to operations, including commercial risk, regulatory risk, sub-sovereign risk and affordability risk. Donors and IFIs have been reactive and developed several innovative mechanisms to address these concerns (e.g., Private Investment Development Group's (PIDG) Garantco, providing guarantees as credit enhancement of local currency debt). Whether these approaches are successful still remains to be seen however, as many of these schemes have only been set-up recently.

Besides the risk premiums that private investors require to operate in regions with higher levels of political and economic risks, and which can prevent many projects from materializing, several other reasons for the slow expansion of PPP in EECCA have been identified in a series of OECD/World Bank conferences. Some key ones are highlighted below:

- The private sector is working already in the most commercially viable cities and seems to be running out of markets and/or projects with sufficient levels of profitability. In EECCA many large or capital cities, which usually offer the best opportunities for the private sector, have either been covered already, or they cannot or do not want to engage into PPP schemes.
- Private investors rightly consider smaller cities and rural areas to be less attractive opportunities for investment. Attempts to agglomerate smaller cities or regional bodies into larger, potentially more attractively-sized projects have met with countless difficulties, frequently stemming from the unwillingness of most municipal authorities to give up their individual utility power bases.
- Regulatory frameworks in host countries are frequently insufficient and unstable. This is often exacerbated by politicians interfering with the management of water utilities, and weak levels of contract enforcement. In conjunction, this generates significant uncertainty about future cash flows for the private operator, since essential cost elements (e.g., wastewater treatment requirements), as well as revenues (e.g. tariffs) can not be anticipated. It is one of the key reasons that private operators put forward to explain the lack of attractiveness of EECCA countries.
- Progress in reforming the legal and institutional set-up of the water sector has been very slow in EECCA. The EBRD's Transition Report identifies EECCA countries as having the lowest transition indicators for their water and wastewater infrastructure⁷. Technical assistance from donors can help to remove many of these obstacles by providing support for capacity building and institutional reform. Private operators have also been calling on IFIs and donors to play a more active role when conflicts occur in PPP projects, to help avoid escalation.
- Revenue streams in EECCA water projects are poor compared to other parts of the world. Not only are tariffs low across the region, overall demand (especially industrial demand) has fallen markedly since the break up of the former Soviet Union. In some areas of EECCA, the current level of water demand is less than half that of the early 1990s. There is a lack of customer metering, other than at block-meter level, and also a prevalence of communal Housing Associations (known as zheks, in Russian) which act as intermediaries, collecting payments for utility services. In some areas even these associations have been abolished without creating any new organisational forms or mechanisms to manage the newly privatised apartment houses including all the maintenance of the internal piping systems. As a consequence, both billing and collection improvements to increase the revenue stream are fraught with difficulties.
- Municipalities have not set tariffs at full cost-recovery levels, and usually such tariffs do not even meet operational costs. Hence, the technical ageing of the water network systems and

⁷ EBRD (2004), Transition Report 2004 – Infrastructure, London

waterworks is often outstripping the investment rate, and this tendency will rapidly grow in the next years. Where the involvement of the private sector operator/investors is seen by municipalities as a mechanism for improving infrastructure investment, the consequences of the private operator setting realistic tariffs to achieve full cost-recovery will require significant tariff increases, which are likely to be politically unacceptable to municipal authorities and unpopular with customers.

- Intensive competition for the best deals in the EECCA water sector has tended to lower private sector's profit margins. To be cost competitive, private operators have to devolve a great amount of work to the local sub-contractors, whose capacity constraints may lead to additional project risk through exposure to under performance.

What can the public sector do to overcome the barriers to PPP in EECCA?

Political commitment to Public-Private Partnerships, at all relevant government levels, is key to their success, since water is perceived by consumers and many politicians as not only an economic good, but also as fulfilling vital social and ecological functions. This has sometimes been overlooked, leading to the rapid loss of political backing as soon as projects encountered the first difficulties. Building strong political commitment for PPP requires time to organize the necessary stakeholder consultations, to build capacity, and to develop studies that help to identify the advantages and disadvantages of different options both within and besides PPP. Management contracts can be used as a first step in building trust on all sides, and leading to more ambitious forms of PPP at a later stage.

The private sector will also look for strong, independent utility regulation as evidence of government commitment toward PPP. The private sector welcomes robust regulatory regimes as a prerequisite for viable partnerships, but such levels of water regulation have not to date been common in the EECCA region.

There is a need to establish realistic tariff levels that will enable full cost-recovery (of both operational and capital investment costs), with the elimination of cross-subsidies between industry and domestic customers. These will improve the level and reliability of the revenue streams in PPP projects. However, whilst governments claim that such changes are imminent, these are frequently stalled at either municipal or sub-national level. There is a need for central government to ensure that these improvements are enforced from above in such circumstances.

Further assistance in the reform process can be provided if the public sector makes every effort to ensure transparent tendering of PPP projects. One of the reasons cited by the private sector for the lack of attractiveness of many EECCA markets has been widely-held concern over tendering transparency. To alter this perception will take time, but any improvements can only be beneficial for the attractiveness of these markets.

Finally, the public sector can work to improve the private sector's antipathy regarding country risk, once projects are underway. The vagaries of local legislation, accounting and taxation policies, plus difficulties of transferring income (the convertibility and also the availability of some currencies) make the operation of many projects a challenge, over and above that necessary for the proper delivery of the scheme.

How can the private sector assist the reform process in the water sector?

There are several ways that the private sector can work towards improving the situation in which these PPP projects operate. As part of technical assistance and educational projects, the private sector

already provides advice and expertise to improve capacity of public bodies at various levels within government, as well as strengthening institutions, such as water undertakers and municipal offices, to create an enabling environment for sector reform. In addition to commercial technical assistance activities, many companies are now developing links with the public sector and with NGOs, to establish a framework for better collaboration. One example of this is the UK Government's PECE Initiative (Partners for Environmental Cooperation in Europe), which is co-funding pilot studies to improve the sustainability of environmental projects across EECCA, in collaboration with the private sector.

Partnering is developing as a concept within utility contracting (notably construction contracts), whereby the parties to a given contract conduct their activities in a far more open and non-confrontational manner; accepting a greater level of trust between the parties involved and including open-book accounting between client and contractor. Whilst this concept may seem a distant one in many EECCA PPP schemes, it could be utilised in many outsourcing contracts as part of the overall PPP process.

The private sector can also demonstrate its commitment to a long-term vision of sector reform within EECCA. The sector is often accused of not showing the long-term commitment needed for water PPPs. Too frequently, private participants are keen to withdraw from projects when difficulties arise, giving both the PPP concept (and the sector as a whole) a less-than favourable name. Such withdrawals are of course made for sound commercial reasons, but there is a degree of 'cause and effect' involved in such circumstances. Perhaps the suggestions put forward in both this and the preceding sections might reduce the tendency for any premature withdrawal?

It is axiomatic that the reform process is reliant upon support from the general public if it is to succeed. Here again, the private sector's experience and ability to improve customer service awareness and delivery can be used to create a better environment for PPP. Moreover, the knowledge gained within the sector from tripartite arrangements (including in addition civil society / NGOs) under such programmes as 'Building Partnerships for Development' will be of great potential.⁸ Such BPD projects have been focused on Latin America and Africa, but the lessons so learned can be applied appropriately to EECCA as well.

How can the international PS and local PS work together to improve water services?

One marked development in parts of EECCA since the Almaty Conference has been the rise in the presence of the local private sector as operators/investors in parts of the region. This has been particularly true in the Russian Federation. Whilst it may not at this stage represent a regional trend, it is nevertheless important to consider the implications for joint international / local private sector activities.

In many ways, the spread of local large-scale service providers (as opposed to small-scale bottled water or tanker providers) offers many opportunities for joint developments, which in turn could improve the attractiveness of the region for PPP:

- local private sector service providers can offer viable services in urban areas that might be regarded as too small for international operators working alone

⁸ Building Partnerships for Development (formerly Business Partners for Development): BPD Water and Sanitation is a not-for-profit membership organisation (a UK-registered charity) which seeks to demonstrate that strategic partnerships involving business, government and civil society can achieve more at the local level to improve access to safe water and effective sanitation for the poor than any of those groups acting individually. For further information see www.bpdws.org.

- the local private sector can combine with international operators to target peri-urban / informal supply areas in addition to urban centres
- local private sector companies can reduce costs and risks for international players
- international companies can provide investment-grade financial status for local companies, to enable them to access debt funding more effectively
- transfers of skills and 'know-how' can occur more effectively between private companies (international and local) and also then between local private and public organisations, thereby improving overall levels of awareness and abilities.

There are therefore a number of areas where there is potential for improvements in PPP in the region, and where the public and private sectors might work to assist further the reform of water and wastewater services in EECCA.

ANNEX: MAIN INTERNATIONAL PUBLIC-PRIVATE PARTNERSHIP PROJECTS IN EECCA

Country	City	Company	Private operator	% owned	Year	Type of contract	Duration, years	Amount of transaction, \$	Committed by IFI, US\$	IFI	Population affected	Source
Armenia	Yerevan	Acea & Company Armenian S.c.a.r.l.	Acea	55	2000	management	5	32 800 000	30 000 000	WB	1 100 000	Blue Pages
Azerbaijan	Armvodokanal	SAUR Sevan Services	SAUR		2005	management	4			WB	700 000	
	Imishli		Berlinwasser International AG(BWI)	74,9	2001	joint venture and management	10			KfW	50 000	KfW
Russia	Butowo		Wassertechnik Essen WTE (now part of EVN Austria)	100	1996	BOT	12, 5				250 000	BW
	Zelenograd		Wassertechnik Essen WTE(now part of EVN Austria)	100	1998	BOT	12, 5				400 000	BW
	Moscow	Rossa	SAUR	50	1993	joint venture	30				n/a	
	St Petersburg		Veolia		2005	BOT for WWTW						
Tajikistan	Dushanbe	Dushanbe Vodokanal (Dushanbe Water Supply Company)	MVV Energie AG (Germany)	n.a.	2002	Management (Services)	3	20 600 000	17 000 000	IDA	700 000	MVV Energie AG
Uzbekistan	Bukhara and Samarkhand		Amiwater		2004	management	4	62 330 000	20 000 000	WB	800 000	PSIRU

REFERENCES:

Code	Source
Blue Pages	Water Supply and Sanitation Blue Pages. World Bank http://www.worldbank.org/watsan/pdf/WSS-Blue-Pages-2003.pdf
BW	Berlinwasser International's website < http://www.berlinwasser.net/ >
MVV	MVV Energie AG, http://www.mvv-investor.de/download/hauptversammlung/Folien_HV_2003.pdf
PSIRU	PSIRU Reports, http://www.psiru.org/reportsindex.asp
WB	World Bank Project Database < http://www-wds.worldbank.org/default.jsp?site=wds >