



The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

*PRIVATE SECTOR PARTICIPATION
IN MUNICIPAL WATER SERVICES
IN CENTRAL AND EASTERN EUROPE AND CENTRAL ASIA*

*FACING A CRISIS OF CONFIDENCE IN PRIVATE SECTOR PARTICIPATION IN THE WATER SECTOR:
MEASURES TO OVERCOME OBSTACLES TO MORE EFFECTIVE PSP*

*CONFERENCE PROCEEDINGS
VIENNA, 02-03 JULY 2003*

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Preface

This report sums up the presentations and papers presented at the Conference on Private Sector Participation in Municipal Water Services in Central and Eastern Europe and Central Asia (ECA), held from 2nd to 3rd July, 2003 in Vienna, at the Austrian Federal Economic Chamber. The conference was designed as a follow-up to the Paris conference organized by the World Bank and OECD in April 2002, and is part of a larger global consultation with stakeholders involved in the Water and Sanitation Sector (the Sector).

The conference brought together Private and Public operators, donors, International Financial Institutions, and members of civil society active in the Sector, as well as representatives of some client government's to share their experiences and emerging lessons with private Sector Participation (PSP) in the Sector, changes in business strategy for investing in the ECA region in view of the changes in the global political and business environment, and discuss ways of maximizing the flow of investment capital and technical know-how to the ECA countries. Representatives of public sector utilities also discussed achievements in the sector under public sector management as a viable alternative to PSP in some cases. The meeting was organized by the World Bank and the OECD, and hosted by the Austrian Federal Economic Chamber (WKO), the main sponsors being Bank Austria Creditanstalt and the Austrian Consultants Association (ACA).

The contents of this report are set out in the same order as the presentations at the conference. The first one and a half days were devoted to discussion of specific topics and experiences related to Public Private Partnerships (PPPs) and PSP in the ECA region, including regulation, financing, risks, and international and domestic market development, as well as some of the lessons learned as seen from the perspective of the donors, IFIs, the public and the private sector. On the second day, participants divided into two working groups, which focused on discussion of two key topics: (i) the potential role of domestic PSP in ECA, and (ii) The potential for improved Public Private Partnerships (PPPs) in water supply service provision in ECA – Measures to overcome obstacles. A summary of the discussions from each of the group sessions was presented to the plenary session at the end of the day. A summary of the key findings and lessons from the conference was also presented before the closing remarks from the conference co-chairs and sponsors. The Conference was chaired by Mr **Jamal Saghir** (World Bank, Water and Energy Director) and Mr **Brendan Gillespie** (OECD Environment Directorate, Head of the Non-member Countries Division).

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Note: The views expressed in this report are those of conference participants, and do not necessarily reflect those of the World Bank, OECD or their Member countries.

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ABBREVIATIONS

EAP	Environmental Action Plan for Central and Eastern Europe
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	Europe and Central Asia Region
EIB	European Investment Bank
EU	European Union
EUR	Euros
IFC	International Finance Corporation (World Bank Group)
IFI	International Financial Institution
ISPA	Instrument for Structural Policies for Pre-accession
MDGs	Millennium Development Goals
OBA	Output-based Aid
OECD	Organization for Economic Co-operation and Development
PFI	Private Finance Initiative
PPP	Private Public Partnership
PQ	Pre-qualification
PRG	Partial Risk Guarantee
PSP	Private Sector Participation
SAPARD	Special Accession Programme for Agriculture and Rural Development
STAN	Central Asian Countries
TOR	Terms of Reference
UFW	Unaccounted-for Water
WSS	Water Supply and Sanitation

1 EXECUTIVE SUMMARY

One of the Millennium Development Goals (MDGs), elaborated at the Millennium Summit in September 2000 and reaffirmed at the Johannesburg Earth Summit in 2002, is to reduce by half the proportion of people without access to safe drinking water and sanitation by 2015. With the expected growth in population, an additional 1.5 billion people will need to be provided with basic water supply, and an additional 2 billion people with sanitation, by the target date. For the ECA region alone, this implies an increase in coverage of 3 million and 2 million people per year for water supply and sanitation, respectively. However, fewer than one in ten developing and transition countries is on track for achieving these goals.

The annual investment needs for the sector in developing and transition economies total about US\$80 billion worldwide, and this will more than double in the next 20 to 25 years. All possible sources of financing—national governments, international financial institutions (IFIs), donors, and the national and international private sectors—will need to be utilized to the maximum extent possible to meet the MDG challenge. And yet there is a decreasing interest among the private sector in providing investment financing to the sector, and an increasing tendency to focus purely on operation issues.

To understand the reasons for their decreasing interest, the World Bank and the Organization for Economic Co-operation and Development (OECD), together with other international organisations, have initiated a listening and learning process as a way to talk to service providers directly. The first event in this series was a conference in Paris in April 2002, focusing on Private Sector Participation (PSP) in Municipal Services in the ECA region. The second conference, held in Vienna in July 2003 and summarized in these Proceedings, focuses on the crisis in private participation in the water sector in Central and Eastern European and Central Asia.

The ECA region has unique problems. There are highly developed urban systems and a high service coverage in rural areas, but the aging infrastructure is collapsing due to lack of maintenance, resulting in high losses; a decline in the provision of safe water, particularly in smaller cities and rural areas; increasing unreliability of services; and rising costs to consumers.

The conference revealed several key issues related to private sector participation (PSP) in the sector, which fall into five main categories:

A. Shifts in Business Strategy

After the experiences of Argentina, September 11, and other cataclysmic events, private sector investors has shifted their business strategies toward less risky countries and projects, and are demanding that donors and IFIs take over all risks not directly related to operations, including currency risk, regulatory risk, payment risk, sub-sovereign risk, and affordability risk. IFIs and donors respond that they cannot assume all these risks for the private sector, and therefore will be more selective in choosing countries in which to support PSP projects.

The ECA region can be categorized into three tiers of countries and markets with regard to PSP:

- First-tier European Union (EU) accession countries, where no help is needed by the private sector. The main driver in this market is EU legislation, to be adopted by these countries (*aquise communautaire*) with support from EU grant financing instruments such as the Instrument for Structural Policies for Pre-accession (ISPA) and the Special Accession Programme for Agriculture and Rural Development (SAPARD), which are available to support these countries in preparing for accession. However, these financing instruments have in some cases actually hindered private sector participation, due to their lack of practical procedures to combine private sector with public grant money. The private sector considers this market to be pretty much saturated.
- Second-tier EU accession countries such as Turkey, Romania, and Bulgaria, and the Balkans, for which the private sector has asked the IFIs and donors to provide assistance in opening up their markets. Turkey is quite advanced in this process.
- Third-tier countries such as Russia, Ukraine, and Kazakhstan, is where new markets could be created. This requires behaviour change, and learning about the technical, operational, financial, and management aspects of private sector participation in the water sector by a critical mass of technicians and policymakers. The Bank has proposed the establishment of an appropriate training center for ECA countries based in Poland.

B. Sector Financing Issues

The international private sector is currently attempting to restructure, shed global portfolios, and reduce project debt, in response to the growing risk aversion of their shareholders following 9/11, the Argentina crises, and corporate bankruptcies. However, the question of how to close revenue cycles has not been answered so far. Only limited funding for developing the sector is available from the World Bank (US\$960 million over the next 3 years from IBRD and IDA) and other donors. This will require a much more selective and stringent targeting of funding, and far better coordination between the major donors and IFIs.

Furthermore, the easy investment opportunities are already being supported, and the private sector seems to be running out of markets with a tolerable level of risk. During the past few years, the market has focused on large cities. Private investors consider smaller cities and rural areas less attractive for investment; and are instead focusing on operations, while depending on donors and IFIs to provide financing.

The private sector considers concessions in ECA highly unlikely, and there is a very limited appetite even for Lease (*Affermage*) contracts. Management Contracts are now considered the safest way of entering new markets, and the donor community, including the World Bank, will continue to support the use of such arrangements where appropriate. However, risk mitigation cannot be done in vacuum. In the future, operators should also be used as

instruments of change, supported by a donor community that plays a more active role in resolving difficulties between the private sector and the client.

C. Regulatory Issues

Private investors attribute the failure of many PSP projects to absent or unclear regulations, or to over-regulation when the government wants to use businesses to achieve social goals. They also complain about the absence of stable and transparent contract administration, and want a clearer statement from IFIs and donors about their readiness to mitigate attendant risks.

It was suggested that the IFI/donor community should develop procedures to combine output-based aid (OBA) with private sector engagement; and should improve Management Contracts to give operators more control, including control over personnel. In addition, the Bank should simplify its procurement requirements; and IFIs and donors should combine lease and *affermage* arrangements with grants and loans.

D. Market Development for New Entrants and Domestic Operators

Generally there are market opportunities for smaller operators in the Region, but some difficulties need to be overcome. Smaller operators tend to focus more on small Management Contracts, which in many cases amount to little more than the provision of consulting services. However, municipalities often are not interested in advice; they expect cash flow to solve their problems. Thus there is a substantial need for facilitation to help the client understand that a step-by-step approach is needed to overcome their problems; i.e., that good management performance is key to attracting international financiers.

To increase the attractiveness of smaller cities, the private sector proposed to amalgamate smaller cities into viable packages and to lower the barriers (e.g. prequalification requirements for size of cities managed, and firm's annual turnover).

For the domestic private sector, the market potential is generally large, and local participation is key for long-term sustainability. However, the capacity of local companies is in many cases very low; businesses in the sector are often unprofitable; and the domestic private sector cannot take over the political and financial risks involved. Donors can play a key role if they coordinate their efforts to support the creation of a better climate for development of the domestic private sector.

E. The Role of Donors

The donor's role in improving competition in the sector lies in providing transparent transactions, determined through: supporting sector framework conditions; thorough project preparation, design, tendering, and execution; and provision of appropriate financing instruments.

The problem of limited funding for private sector projects requires more concerted action on the part of the IFI/donor community. Participants discussed the need to improve coordination

among the different organizations, with the most powerful donor in a country taking the lead, since non-coordinated activities can weaken all of the efforts.

The IFI/donor community view PSP as one vehicle for improving water supply service provision, but not as a panacea. They will continue to support PSP projects, where appropriate, as instruments of their development work, and are prepared to play a more proactive role during transaction and project implementation by providing simple, standardized procedures. They however demand that the private sector also play its part by adopting transparent procedures and a clear code of ethics, and by accepting that risk is part of the business. The IFIs/Donors warned that underbidding has created more problems than solutions.

F. Next Steps

As a next step, the World Bank will enter into discussions with authorities in Turkey, followed by Bulgaria and Romania, to open up markets to expand market opportunities for PSP. Another task will be to support the creation of future markets where feasible in the Region (e.g. Russia, Ukraine, Kazakhstan). The Bank together with other partners are considering establishing a training center for FSU countries, probably in Poland, that will provide training for sector practitioners in among other things, PSP issues. Bank staff will organize follow-up discussions on market development, including discussion to advance the concept of management contracts. The Bank will also continue to use Management Contracts as a vehicle to transfer modern financial and operational techniques to ECA client countries, get the public acquainted with use of PSP in the sector, as well as to expose, at minimum risk, private operators to possible future markets in ECA.

There was also a consensus that more work was needed on the use of domestic operators, pure public sector model for water utility management, and generation of domestic sources of investment financing.

2 INTRODUCTION

2.1 SCOPE OF CONFERENCE

The two-day conference held in Vienna on July 2 and 3, 2003 was attended by 78 delegates, including representatives of 13 major private operators active in the ECA region, 14 bilateral donors and IFIs, and 13 representatives of governments and civil society, including NGOs and academia. The conference was a follow-up to the Paris conference of April 2002, and aimed at sharing knowledge and experiences among private operators, donors, and IFIs about private sector participation in providing municipal water and sanitation services in the ECA region. The conference did not cover broader water resources issues, such as irrigation and drainage, energy, environmental services, industry, and navigation, all of which, taken together, comprise integrated water resources management.

2.2 CONFERENCE OBJECTIVES

The overall objectives of the conference were to provide a forum at which operators could present new business strategies, in view of the changing global political and business environment; and stakeholders could share experiences, listen, and learn more about PSP and public-private partnerships (PPP) in the ECA region.

More specifically, the objectives were to identify and analyze:

- key lessons, including reasons for successes and failures of PSP in the ECA region;
- opportunities and obstacles to further PSP in the ECA region, given the private sector's crisis of confidence regarding participation in the WSS sector;
- strategies to increase financing in the water and sanitation sector, in order to meet the MDG targets;
- ways to encourage new entrants to the market;
- ways to increase the attractiveness of water sector investments for the domestic private sector, particularly with regard to serving smaller cities and rural areas;
- risks, and discuss how to better allocate them among all players;
- obstacles that hinder donors and IFIs from increasing the number and size of water sector projects;
- what role the IFIs and bilateral donors should play to facilitate greater PSP/PPP engagement in water sector projects.

3 SUMMARY OF DAY 1

3.1 PRESENTATIONS

This section summarized the presentations, key statements, and issues raised during the first day of the conference. The discussions focused on two broad themes: (i) experiences and lessons learned from PSP; and (ii) private sector perspectives. Full versions of the presentations are attached in Annex B.

3.1.1 Session 1 – Opening Remarks

3.1.1.1 Private Sector Participation in Municipal Water Services in Central and Eastern Europe and Central Asia

(Mr. Jamal Saghir, Director, Water and Energy, World Bank)

Mr Saghir set the context for the conference by describing the current situation in the water sector globally with a focus on the ECA region.

During the Millenium Summit in September 2000, United Nations Member States pledged in accordance with the MDGs, to halve the number of people without sustainable access to safe drinking water by 2015; and further agreed, at the Johannesburg Earth Summit in 2002, to reduce by half the number of people without access to basic sanitation, also by 2015.

Allowing for the expected growth in population, attaining these targets will mean new global connections of more than 250,000 people a day for water supply, and more than 300,000 a day for basic sanitation, every day for the next 11 years. For the ECA region, this means the provision of water supply to 3 million people per year, and the provision of sanitation to 2 million people per year.

However, fewer than one in ten developing and transition countries are on track toward achieving these goals, with barely 30 to 40 percent of their yearly targets achieved. This performance is worse compared to the attainment of other targets, such as child mortality, health, and the completion of primary school education. Moreover it is well known that access to safe drinking water and adequate sanitation is key for improving health, education, and environmental outcomes.

The ECA region faces unique problems in municipal WSS. Highly developed urban water and sanitation systems do exist, and service coverage in the rural areas is high. However, costs exceed the current income levels of consumers; and the old infrastructure is collapsing due to lack of maintenance, causing a progressive decline in the reliable provision of safe water. These problems are concentrated mainly in the eastern and southern parts of ECA, and particularly in secondary cities and rural areas.

Statistics reveal that costs of about US\$50 billion are needed to meet water supply and sanitation MDG needs alone, which is a staggering 25 percent of the total annual investment in infrastructure. However more than capital investment is required to meet these challenges; there must also be reform to ensure that resources are used cost-effectively and directed to the

highest priority investment needs. Mobilization of resources from all sources needs to be enforced. A further obstacle is the low ratio of price to cost, which is about 0.3 in the water sector, compared to 0.8 in the gas sector and 1.6 in the telecom sector. A factor smaller than 1 indicates that an investor cannot reach full cost recovery without receiving some form of subsidy.

Governments also face the challenge of creating a regulatory system that balances the interests of different stakeholders. Service providers aim at maximizing profits, consumers want low tariffs, excluded (poor) households demand to be served, and the State wants to maximize sales and concessions in order to protect its influence and minimize state subsidies.

These challenges require donors, including the World Bank, to change their roles. Each country needs to define its local goals within the framework of the MDGs, and donors must adapt and respond to the country goals. Donors need to be involved at all stages of reform, and improve their monitoring of results. The World Bank needs to scale up current efforts, increase the effectiveness of its support, and focus on countries where potential impact is highest. They must work across sectors, with and through external partners.

The Camdessus panel was initiated after the 2nd World Water Forum (De Hague, April 2000) to identify ways to finance water infrastructure. As a starting point, it suggested more than doubling the current global investment of US\$ 75 billion per year to US\$ 180 billion per year, focusing on water supply and sanitation. It has drawn up 87 recommendations; the main priorities are: (i) for governments to develop detailed WSS strategies; (ii) optimizing the use of existing financial vehicles; (iii) the introduction of new financial vehicles; and (iv) to immediately begin the process of long-term sector reform.

Recent trends in World Bank Group thinking include: (i) a renewed focus on infrastructure; (ii) focus on service delivery to all, including the poor; and (iii) moving beyond the Public-Private debate – it is about giving access to water supply and sanitation services.

3.1.1.2 Overcoming Obstacles to Private Sector Participation

(Mr. Brendan Gillespie, head, Non-member Countries Branch, Environment Directorate, OECD)

Mr Gillespie gave an overview of OECD's engagement in the ECA region, focusing on the water sector. Studies carried out under the Environmental Action Plan for Central and Eastern Europe (EAP) Task Force Secretariat of the OECD Environment Directorate clearly identify the huge financing gap between expenditure needs and available financing. In terms of cost per connected inhabitant per year, the gap ranges from 13 EURO in Eastern Kazakhstan to 34 EURO in Pskov, Russia.

Reaching the MDGs on water in the countries of Eastern Europe, Caucasus and Central Asia (EECCA) will pose a significant financial challenge. Presently, the finance available to water utilities barely covers half of the costs for operating and maintaining water systems at their current low levels of supply quality. In some places this may be as low as 25%.

Given this important financing gap, all possible sources of finance should be taken into account when looking for the possibilities to overcome this situation. Figures from the countries of the former Soviet Union indicate that still user charges and domestic public budgets provide more than 95% of the finance for the water sector, and it is unlikely that this will change substantially, even in the event where foreign aid were to be increased substantially.

Work that has been carried out in the framework of the OECD/EAP Task Force indicates that in some cases there may be significant opportunities to raise user charges, provided that adequate measures are taken to protect the poor. Only in Kazakhstan and Moldova do water charges represent close to 4% of average household income. In other places of the CIS these can be as low as 0.5%. Similarly, there may be opportunities to raise domestic public spending on water infrastructure, too. While some CIS countries do spend a similar share of their GDP on the environment as OECD countries (2%) many others spend far less than this (e.g., Azerbaijan spends less than 0.5% of its GDP).

But there will clearly be limits to the amount of additional finance that can be raised internally and externally, and in some cases this may not suffice to close the gap. It is therefore crucial that all opportunities for cost reduction and improvement of utility efficiency are being exploited, including the reform of tariff systems, the adjustment (in many cases downsizing) of infrastructure development objectives, more efficiency in the usage of donor money, governance reforms, as well as the usage of private sector management where this is appropriate.

The OECD/EAP Task Force works in this direction by supporting and facilitating the environmental strategy objectives adopted by Environment Ministers at the “Environment for Europe” conference in Kiev, May 2003, and through its WSS network. The Task Force provides tools, guidance and political support for reformers in the ECA countries; including by promoting partnerships between donors and ECA countries and working with banks to overcome obstacles. The dialogue with the private sector is another step in this direction.

3.1.2 Emerging Lessons in Private Sector Participation in ECA over the last 10 Years (Mr. Sohail Khan and Mrs. Olena Maslyukivska, Water Engineering and Development Centre, WEDC, Loughborough University)

The presentation summarized findings of a study, carried out by the consultants, that (i) reviewed the status and trends of PSP in the ECA water sector; and (ii) assessed the levels and impacts of PSP in four focus countries (Czech Republic, Estonia, Hungary, and Poland).

Based on desk studies and field work, the study found that PSP in the ECA region has increased at a steady pace over the past ten years (1 project in 1992, and 60 projects in 2002). There is a clear dominance of Management- and Concession Contracts; while Operation and Maintenance (O&M), Lease, Build-Operate-Transfer (BOT), and Divestiture contracts are less evident. Based on several factors, such as market size, economic liberalization, and democratic transformation, PSP projects are either feasible, of undetermined feasibility, or clearly not feasible.

The study highlighted trends with respect to PSP in the four focus countries, which started off with similar levels of PSP at the beginning of the transition, but have achieved very different levels of involvement to date. These focus countries contribute two-thirds of the region's PSP projects. Although the four focus countries differ in their PSP models, they all have three issues in common: (i) the public sector controls the conditions for PSP; (ii) asset ownership is separated from operations; and (iii) local authorities are becoming the leaders in PSP projects.

In the focus countries, several lessons have emerged from PSP performance. On the one hand, PSP has had significant successes, and has transformed water utilities into a more dynamic business, with increased managerial efficiency, personnel training, technology transfer, an increased focus on customers, and a decrease in leakage. On the other hand, there have been some failures for instance: PSP has not significantly increased the influx of capital and new infrastructure investments, and sanitation is neglected by the private sector in all four focus countries. Moreover public opinion of PSP is generally low. Factors that contribute to improving this image include among other things, transparency in tendering, participation in community life by the private sector, and planned employee reduction strategies.

The role of IFIs and the donor community in the ECA region is important and should be aimed not only at supporting reform of the legal and regulatory framework, but also at Technical Assistance support for new projects; facilitation of PSP; and mobilization of resources from national budgets, donors, IFIs and the private sector.

3.1.3 Regulatory Oversight of Water Sector in ECA

(Mr. Chris Shugart, Consultant)

The presentation concentrated on institutional issues, rather than on the substance of regulatory rules. Many setbacks and failures of PSP can be attributed to regulations that enforce public control over private business, in an attempt to achieve social goals.

There are three key aspects of a regulatory system: (i) rules regarding political and technical issues, risk transfer, and incentives; (ii) definition of the types of entities involved; and (iii) the responsibilities of the different entities.

Based on several case studies, emerging lessons from the current regulatory systems in ECA are: (i) the need to reduce regulatory discretion, with a more complete and precise set of rules; (ii) the need to make greater use of independent third-party interveners; and (iii) the need to match the intervener with type of rules at issue. A set of clear and well-defined rules will help to prevent political interference, arbitrary decisionmaking, and difficulties in negotiations among parties to a contract.

3.1.4 Water Sector Financing Needs

3.1.4.1 The Turkey Experience

(Mr. Sudipto Sarkar, World Bank, and Mr. Arif Erden, Turkish Treasury)

In Turkey, urban water supply coverage is 98 percent, and urban sewerage coverage is 92 percent; however, urban wastewater treatment amounts to a mere 6 percent, with a considerable regional imbalance in coverage and quality. Service delivery in Turkey is the responsibility of: (i) 16 ISKI companies in metropolitan areas, covering 45 percent of the population; (ii) 450 municipalities covering 40 percent of the population; and (iii) almost three thousand smaller municipalities with populations of less than ten thousand, covering 15 percent of the population.

Over the past 10 years, the central government (DSI, Iller Bank, Treasury) has played a key role in financing the water sector (US\$750 million per year). In total, sector investments amount to around US\$1.4 billion per year; however, inefficiencies in operation result in losses up to 50 percent. In addition, the cost of EU accession is an estimated US\$20 billion.

At the central level: (i) the state cannot afford to continue its financial support, as in the past 10 years; (ii) emphasis is given to developing viable projects; (iii) many central agencies are involved in the project cycle, and their roles and responsibilities need to be more clearly defined; and (iv) efficiency in investment and operation needs to be increased.

At the local level: (i) municipal sector reform could minimize public expenditure; (ii) a type of "ring-fencing" of utility operation helps increasing synergies; (iii) regulations to benchmark performance are being developed; and (iv) the focus is on service rather than investment.

The public sector has an important role to play in: (i) increasing the efficiency of operations, thereby increasing cash flow for investment; (ii) bringing in capital to reduce the public investment program; and (iii) bringing in international experience.

3.1.4.2 PSP in Water Projects - The EIB Experience

(Mr. Christoph Gleitsmann, European Investment Bank)

The European Investment Bank has a global lending mandate, with the prime objective of supporting the implementation of EU policy according to directives. Projects are assessed on the basis of both credit and project risk. EIB is neutral toward PSP, in terms of seeing it as an optional tool rather than an inevitability.

In the water sector, EIB has approved loans of more than EUR 2 billion over the past 10 years, and has carried out more than 300 project appraisals over the last 5 years. Based on EIB studies, the percentage of population worldwide served by the private sector hardly increased—from 7 to 8 percent—between 1999 and 2002, and the number of PSP projects actually decreased. In both the European Union and the United States, the amount of financing decreased by 70 percent, with further reductions to come. PSP experience in the EU accession countries has been unsatisfactory due to: (i) lengthy preparatory times because of

prolonged tender procedures and inexperienced authorities; (ii) inappropriate bid criteria; (iii) inability of PSP projects to achieve EU directive service parameters; and (iv) the failure to include mechanisms for accommodating EU funds; e.g., ISPA.

Several conditions need to be met for PSP to succeed in the accession countries. There needs to be a far stronger political commitment, beyond the next legislation period for PSP. A regulatory system is needed that covers all forms of PSP. The support of the European Commission (EC) is required institutional strengthening. Municipal companies need to be strengthened by increasing their creditworthiness, as in Romania (co-financed by EIB and the European Bank for Reconstruction and Development, EBRD).

ISPA funds, cohesion funds, and structural funds will remain the main drivers for priority works to achieve compliance with EU directives, and individual studies will be necessary to determine appropriate PSP approaches.

The IFI/donor community is called on to explore innovative financing mechanisms such as sub-sovereign lending and the development of PSP in the light of the ISPA-PPP (Public Private partnership). Operational guidelines for using grant funds for PSP projects can be downloaded from the following site:

http://europa.eu.int/comm/regional_policy/sources/docgener/guides/pppen.pdf.

The following conclusions can be drawn from EIB experience in the accession countries: (i) key issues for PSP are good governance, matching partnerships, transparent tendering, and adequate incentives; (ii) local authorities need to focus on water sector development by making use of EC grant funds for capacity building; (iii) the private sector should compete for contracts based on true costs, and should focus on providing best practice services, at least cost; (iv) the IFI/donor community should further develop financing tools and support authorities in capacity building and decisionmaking. The EIB does not see a shortage of financing, so much as a lack of good projects.

3.1.5 Session 2 – Operators’ Experience

3.1.5.1 Performance-based Management Contract for Hidrosistemy Radiniki, Kosovo (Mr. Alexander Beck, Gelsenwasser)

The management contract in Kosovo has three main objectives: (i) management of the water supply system (population of 214,000 in 2 cities and 72 villages); (ii) support for urgently needed infrastructure repairs; and (iii) development of a model for integrated water resources management.

No legal framework was in place to guide such arrangements prior to implementation of the management contract. Moreover, the utility had an inefficient organizational structure with no accounting, controlling, monitoring, or reporting system. Unaccounted-for water amounted to 75 percent, and the collection rate was a mere 38 percent. Salaries had not been paid for 2 months, and operating costs generally were not covered.

During the contract period of 24 months, the utility developed a customer database, and a new tariff structure that included: (i) appropriate tariffs for households, industry, and public consumers; (ii) incentives to use safe water through progressive tariffs; and (iii) a subsidy system for the poor.

Challenges during the implementation period were: (i) the absence of a legal and regulatory framework; (ii) lack of clear responsibilities for administrative bodies, (iii) lack of a local counterpart; and (iv) a slow responding contract authority.

3.1.5.2 Delegated Contracts – Schemes for Financing the Infrastructure (Mr. Jean-Patrice Poirier, Veolia Water)

Veolia Water has had successful PSP projects in the Czech Republic, Hungary, and Romania, but has encountered problems in Turkey (Cesme), Kazakhstan, and Georgia (Tbilisi).

In Turkey, three key problems had to be dealt with. First, the duration of the negotiation period was too long; contract signature took place in March 2003, three years after tender. It took a long time for all the clarification meetings between World Bank owner and Veolia Water. Second, the condition of the infrastructure was far worse than had been initially reported. Third, there was a failure of design and probably also a failure of supervision of the works during construction.

In Kazakhstan, the main problem is related to the tariff structure. So far the regulator has not approved the tariff, which today is US\$.08, but will probably need to double within five years.

In Georgia, the situation is complicated and more difficult to solve. First, a change in the World Bank loan took place, which caused the US\$25 million earmarked for 5 years to be split into US\$15 million over 3 years and US\$10 million over 2 years, effectively creating a shortfall. This needs to be covered by some entity, such as local government, if tariffs cannot

be increased appropriately. The company is considering withdrawing after the initial three years if the World Bank is not prepared to extend the loan after this time.

Based on Veolia's experience, four important conclusions arise for discussion: (i) EC funds seem to complicate PSP instead of accelerating it; (ii) transaction periods are too protracted; (iii) a long-term commitment by the private sector must be accompanied by a similar commitment to raising tariffs; and (iv) the IFI and donor communities should also participate in clarification meetings.

3.1.5.3 Lessons from the Yerevan Management Contract

(Mr. Andrea Mangano, ACEA)

Key problems encountered at the start date were, among others, availability of water for only 7 hours a day, a management contract not harmonized with the Armenian regulatory system, unpaid salaries of the utility staff, a 12 percent collection rate, and unrealistic bidding dates.

ACEA achieved a major restructuring of the water utility, and after three years, energy consumption was reduced by 20 percent, daily average water distribution increased to 13 hours, and the collection rate increased to 54 percent.

Key lessons learned from the Yerevan management contract are that: (i) the operator must not be left alone - the IFI/donor community must take a more active role during the project deal. The management contract needs to be based on the applicable regulation system, and the IFI/donor community should back up the operator in implementing the contract; (ii) performance targets must be based on reliable data; (iii) the IFI/donor community or central government should guarantee working capital from day one; and (iv) the project management unit should be aware of its functions as a technical controller and decisionmaking body.

3.1.5.4 Instability in the Business Environment in ECA

(Mr. Louis Petrique, SAUR International)

Recent changes in the business environment (Iraq, Ivory Coast) have had two major consequences for the water sector: (i) long-term contracts are incompatible with short-term world views; and (ii) basic concepts change too slowly to remedy the deteriorating system.

In most countries, the question is no longer how to attract private investment, but rather how to attract bilateral and multilateral aid, which leads to Management Contracts and Lease Contracts. The concession model seems to be outdated. The role of the operator in this new context is to: (i) optimize the investment; (ii) improve operations; (iii) be a catalyst to attract local and international funding; and (iv) no longer be a major investor. The role of the donors will be to select the countries where public-private partnerships will be possible.

3.1.5.5 Vision for the ECA Market by an Operator

(Mr. Jean-Claude Ambert, Suez International)

The ECA region is heterogeneous in terms of risk allocation, and an operator is highly selective and cautious – he is not a banker and so has to focus resources on realistic projects. Contract principals must be linked to the operator's responsibility; only then is the operator willing to take over guarantees. All financial requirements needed for operation, investment, and remuneration must be in place, as does an adequate currency. Soft loans should be made available for financing and/or subsidies for investment. The operator will take risks only on issues where he controls and manages an operation, but not on construction, financial, monetary, contractual, or political risks.

There are pros and cons related to original management contracts. On the one hand, they allow an operator to be involved without investments, and enable a performance-based approach. On the other hand, management contracts do not allow control over local staff, there are serious restrictions on other staff, and the contractual environment is often too rigid and not adapted to the local context.

Operators in the ECA region envision: (i) remain active in future EC accession countries; (ii) playing a role in creating tailor-made contractual arrangements; and (iii) accepting clear responsibility where risks are beyond the operator's control.

3.1.5.6 Transformation of a Public Utility: The Case of Leipzig

(Mr. Juergen Wummel, Sachsen Wasser GmbH)

Before 1990, VEB was an overstaffed state-owned enterprise, and water prices were heavily subsidised for both industry and private households. Under this system, not even half the operating costs could be covered. Two concession contracts focusing on O&M, billing and collection, pricing, and capital investment led to the creation of a new utility, KWL. This resulted in: (i) a reduction of water consumption from 200 to 90 liters per capita per day; (ii) a reduction in unaccounted-for water to some 18 percent; and (iii) an expanded supply area.

In order to increase efficiency, a process-based organizational structure was introduced, "marginal" know-how was outsourced, and the management information system was optimized by SAP, GIS, and ISU. A comprehensive cost/profit approach was realised, including benchmarking elements.

The performance of a water utility depends less on ownership than on management. Public utilities are at least as competitive as privately owned utilities. They have a stronger commitment to the region by generating surplus values such as creating new local jobs. Finally, tariff increases need to go hand in hand with service improvements.

3.1.5.7 Public Management Experience of La Coruna Water Supply, Spain (Mr. Jose Antonio Orejon, La Coruna Water Supply)

Politicians in La Coruna decided to organize the city's water supply through EMALCSA, which supplies 350,000 people, is fully owned by the city council, and is governed by commercial laws as a limited liability company. The city council appoints a board of directors, who in turn appoint the general manager. Staff are non-civil servants and are selected competitively. Public control is provided by municipal intervention and the financial court; private control is provided by independent auditors, inland revenue inspection, and publication of annual financial reports. Financial sources include revenues, subsidies from administration (although none from the city council), and loans taken out by the company for investment. Water tariffs are at full cost recovery (an EU requirement). Internal control is done by benchmarking and public opinion research. Technical and financial indicators of the utility are generally good.

In 2002, 48 percent of the water services in Spain were provided by the private sector, and this is trending upward; while the private sector share in water services in the EU is only 35 percent.

Public sector management has a number of strengths: (i) assets belong to the local council; (ii) the public sector can be efficient and profitable as private sector; (iii) it gives more consideration to social aspects; (iv) profits go back into services; and (v) there are better linkages between the company and consumers. However, it also has weaknesses, including: (i) the risk of political interference; (ii) periodic changes of managers and boards of directors due to elections; and (iii) a rigid hiring process.

Private sector management also has strengths: (i) new technologies can be implemented easily; (ii) there is a greater change of innovation; (iii) hiring procedure are simpler; and (iv) services are subject to competition. The disadvantages of private sector management are: (i) a narrow view of success (only economic indicators); (ii) rapid withdrawal if results are not achieved; (iii) the likelihood of frequent changes in ownership; and (iv) trends toward monopoly, which can eliminate competition.

The conclusions are that, while both systems can perform efficiently and be cost effective, it is important to define management models such that both systems can compete fairly; and that performance evaluation should include social as well as economic criteria.

3.2 DISCUSSION AND CONCLUDING REMARKS

This section summarizes the discussion that followed the presentations, as well as the concluding remarks made by co-chairman Brendan Gillespie at the end of the first conference day.

3.2.1 Discussion

There is wide agreement about the need for IFIs and donors to be stronger advocates for private sector operators, particularly in critical situations. This will require better coordination and communication among donors and IFIs.

Donors, for their part, would like the private sector to be more innovative by, e.g., developing new models, considering franchise systems, and enhancing the involvement of local partners. The private sector has tested several new models, but lacks financing to implement them. Consumers have to pay for the service, and if they cannot afford to pay, this leads to money transfer from north to south, which is a question of aid policy; these are decisions for the donors.

Private sector operators are ready to take the risks associated with operations, but they are not bankers. They are often able to raise funding, but IFIs and donors are often able to provide cheaper financing. Equity capital is the most expensive form, so why should shareholders invest in Central Asian accession countries if similar opportunities exist in the much less risky accession countries like Western Europe or the United States?

The presentations of public service companies such as La Coruna lead to the conclusion that the public sector is able to perform efficiently and cost effectively. The private sector points to the fact that it is carrying out services in an industrialized West European country is very from doing so in the ECA region. In any event, representatives of public organizations are always very cautious about getting involved in projects in ECA.

Rather than supporting a private sector versus a public sector approach, the key is how to become cost-effective and provide an efficient service, and the driver for this is entrepreneurship. Several of the larger operators are actually mixed private and public companies. Even now, private and public operators fully compete with each other.

The private sector claims that local authorities have the unrealistic expectation that private operators will invest and solve all their problems. The private sector asks that IFIs and donors play a stronger role in informing local authorities about what PSP means, and what they can expect.

3.2.2 Concluding Remarks

It has become very clear, not just from the conference, but also from earlier discussions and meetings, that the private sector needs to be more strongly involved if the MDGs are to be achieved. But the world has changed and the private sector has become increasingly more

averse to risk, and needs an appropriate incentive and risk mitigation structure in which to function.

The private sector is looking for help from the World Bank and other donors in the following distinct areas:

- The private sector is frustrated over the long negotiation period needed to finalize a deal. All players need to be included in the process to share best practices, and IFIs/donors need to be more strongly involved in the role of honest broker.
- The bidding process needs to be restructured to avoid the problem of underbidding.
- Contracts need to be structured in such a way that the private sector is given the means to achieve the contract objectives, while being able to deal with risks in an appropriate manner.
- Some guidance is needed on the issue of tariffs.
- Appropriate instruments need to be developed to mitigate and counter risks, as noted in the Camdessus Report.

4 SUMMARY OF DAY 2

4.1 PRESENTATIONS

Session 3 – Competition in the Water Sector

4.1.1 Market Development for Private Water Utility Management in the ECA Region (Mr. Christopher Schmandt, Consultant)

A market development study was recently carried out as a first step toward increasing the pool of international participants and expanding the sphere of activity. The study revealed only limited success in serving the entire market. Major cities with affluent customers are covered by sufficient services whereas the poorer sections of the population, secondary cities, and rural areas lack sufficient coverage. There also appears to be limited success in attracting full participation of the private sector. Whereas major operators are well established in the region, consulting firms, utilities, and construction companies have not been able to establish themselves adequately so far. Thus there is a question of whether the barriers to market entry are real or perceived, and how can they be solved or mitigated.

The IFI/donor community can play a key role in encouraging PSP by: (i) being more proactive during the life of the project, and providing simple, standardized procedures; (ii) stressing an incremental approach and quality of service as a way to reduce costs; and (iii) assuming a greater share of the risk.

The private sector, for its part, needs to maintain a high level of transparency and project ethics and be proactive in team building. Private operators also need to be proactive in team building, and must understand that risk is part of the business.

The public partner should focus on transparency, responsibility, accountability, streamlining regulations, and being proactive in structuring and negotiating the deal.

4.1.2 Promoting Competition in Public Private Partnerships in the Water Sector (Ms. Annika Frank, KfW)

In the water sector, competition is mainly *for* the market and not *in* the market; therefore, adequate project preparation and transparent tender processes are the vehicles for improving competition in the sector. The donor's role in this competition for the market lies in providing transparent transactions, determined through: (i) sector framework conditions, (ii) project preparation, design, tendering, and execution; and (iii) financial instruments.

Within the sector framework, there are several possible areas of intervention, including preparation of a suitable political environment for PSP; creation of an appropriate legal and regulatory framework; strengthening of sector institutions; and increasing donor coordination. In addition, project preparation, design, tendering, and execution are supported by

instruments such as conceptual studies, transaction advice, tender criteria (e.g., scope of services), and the provision of technical advisors for execution and contract monitoring.

KfW offers different financing instruments, including the PPP Facility (grants for project preparation, tender documents, etc.), budgetary funds, a combination of budgetary funds and market fund, and interest-subsidized loans. PSP is one vehicle but not a panacea. At present, KfW implements two management contracts and two concession contracts in the ECA region, and two additional management contracts are in preparation.

4.1.3 Regulatory Challenges Promoting Competition in the Urban Water Sector

(Mr. Antoine Grand d'Esnon, France Service Public, 2000)

An imaginary case study of a town of 200,000 inhabitants (consuming 100 liters per capita per day) was presented. In this case study, 10,000 connections, including water meters, need to be restored. The existing network needs to be rehabilitated (40 m/connection 400 km), a water plant is to be built (40,000m³/day, extendable to 80,000 m³/day in 2012), and a reservoir of 30,000 m³ with extension to 60,000 m³ in 2012.

Several theoretical calculations were done using realistic unit prices for pipes, meters, and water treatment. Based on these investment calculations, the following conclusions were drawn: (i) no competition can replace the necessary subsidies; (ii) no subsidy will replace knowledge and professionalism in utility management; (iii) capital costs more than water; (iv) the financial risks are greater than the operating risks; and (v) tariff collection must be guaranteed.

4.1.4 Preliminary Findings of Study on Domestic PSP

(Mr. Sohail Khan, WEDC, Loughborough University)

The domestic private sector in the ECA region is heterogeneous in terms of registration, share holding, non-registered firms, associations, and turnover. However, domestic firms are known for: (i) flexibility, (ii) accessibility, (iii) local employment generation, and (iv) sustainability.

The observed barriers to domestic PSP are: a general negative perception, an under-evaluation of their contribution, and difficulty in entering into the market due to restrictions on capital and procurement processes. To overcome these barriers: (i) entrepreneurs need to be encouraged; (ii) niche areas such as sanitation service to need to be identified; (iii) procurement strategies and policies need to be more sensitive; and (iv) there must be fair competition supported by appropriate contract packaging and procurement procedures.

4.1.5 Case Study of Domestic PSP in Syzran, Russia

(Mr. Sergei Sivaev, Institute of Urban Economics)

In the Russian Federation, the municipality is typically the asset owner in the water sector, except for private and state-owned assets. The same is true for the management organization

– municipal enterprises dominate the management units, except in the case of private companies. In contrast to other ECA countries, management contracts are not typical in Russia for PSP projects. In Syzran, a trust management contract is currently being implemented, and in Perm, a lease contract with investment obligations is currently operating.

The Russian trust management contracts do not include any incentives for performance and efficiency, and the contract period must not exceed five years. In Syzran, the trust management contract duration is two years, and the domestic private operator does not act independently, since he represents an industrial enterprise. This creates a conflict of interest between the enterprise and the consumer. In Perm, the contract was signed in April 2003, and the private operator is an independent partnership.

The main problems with the two contracts are that: (i) asset registration is delegated to the contractual management; (ii) the tariff policy is highly complex and time consuming, and involves several authorities and administrative bodies; and (iii) only certain production and investment obligations are to be carried out by the operator.

4.2 CONCLUDING REMARKS

In his concluding remarks, Co-chairman Brendan Gillespie made three main observations:

- There is still a wide gap in expectations between private operators and the IFI/donor community. Private operators demand more support in risk mitigation, sub-sovereign lending, and more involvement by donors in facilitating and finalizing contracts. A survey (*Schmandt presentation*) demonstrated this situation precisely. On the other hand, the IFI/donor community's input in the WSS sector includes lending, technical assistance, and forums for sharing ideas, all of which result in policy reform, institution building, and ultimately, physical investment. Private operators and IFIs/donors have common objectives, but there is a bridge still to be built.
- Compared to the Paris conference, where mainly capital cities were discussed, now we are shifting towards smaller cities and rural areas. The types of partnership and instruments needed to address the problems in these areas have not been discussed enough.
- The third observation is about time; there are some contradictory elements. PSP is still a young industry. Examples on which we can base our experience are scarce. It also takes time to establish effective co-operations and develop tools that can be effectively assessed. On the other hand, the international community is already lagging behind on the MDGs. Somehow, the process has to be accelerated.

4.3 WORKING GROUP SESSIONS

Two parallel working group sessions were held, focusing on the following topics:

1. Increasing the potential for domestic private sector participation in water supply service provision in ECA.
2. The potential for improved PPP in water supply service provision in ECA – measures to overcome obstacles.

Each group was chaired by a facilitator and attended by a rapporteur, who presented the group's findings to the plenary session.

4.3.1 Working Group 1: Increasing the Potential for Domestic PSP in Water Supply Service Provision in ECA

The facilitator was Mr. Hannes Posch, ACA; the rapporteur was Mr. Olexander Kucherenko, PADCO, Ukraine. Group 1 had four main findings:

A. Market potential for domestic PSP?

The working group concluded that there is large market potential for the domestic private sector, but that the capacity of many local companies is low. Local participation is important for the success of projects; without it, no amount of effort will succeed. The key to evoking full domestic private sector potential is that the business must be profitable for them. The domestic private sector is possibly more profit oriented than the international private sector.

However, the domestic private sector cannot take over political and financial risks. Donors can play a key role if they better coordinate among themselves, and create a climate for development of the domestic private sector.

An approach for serving big cities will always be a combination of international and local companies. However, international companies face difficulties in identifying trustworthy and capable local partners interested in this kind of business. Ideally, the domestic partner should be willing and able to take over the business later on.

Donors could also support development of the local private sector by easing the entry criteria for domestic companies. Large companies with high turnover are not needed so much as people dedicated to the sector.

B. Which domestic industries will most likely play a role?

Answers to the question were discussed on the basis of several countries, since the situation differs significantly from country to country, and is not uniform in the ECA region.

- The examples of Russia and Romania:
There are the large electricity and the gas utilities that could step in. Although they

have limited know-how, they have political backing and capital. They are expected to take over a large portion of the domestic water supply and sanitation market.

- The example of Turkey:
In other countries, where no such strong utilities exist, the situation is different. In Turkey for example, large civil works contractors have taken up these municipal services, but in the end, neither the civil works contractors nor the municipalities were satisfied, so they parted ways. Civil works contractors primarily want to construct things rather than operate facilities, and typically aim for short-term profits.

This leads to the question of what should be done. A possible solution is to support the engagement of specialized local service companies, as in the case of Diyarbakir. However, this requires time and patience.

- Local service companies at Diyarbakir:
The municipal administration identified an information technology company that had been contracted to do the billing for the communal services. Under that arrangement, the collection rate increased from some 30 to 75 percent. The same approach could be used to reduce unaccounted-for water, with the help of good local and professional partners.
- Existing utilities, potential future players.
Existing utilities may become future partners. They have the know-how, but their engagement may be hampered by legal problems.

C) What is the best way to stimulate domestic public private partnerships?

Several approaches are possible. The working group agreed on the following points:

- Demonstration cases (pilot projects) are needed to show local people how the business works. Operations by local companies in smaller towns is feasible with some initial assistance and training support.
- Bundling of several smaller towns into one contract package has been proposed, to achieve economies of scale. The working group noted, however, that it can be extremely difficult to get several town administrations under one contract.
- Good project preparation is essential, and can save up to 30 percent of the costs, which finally have to be paid by the consumer. Projects need to be prepared independently of any interests (supplier, political, etc.), by a group of independent experts who can define least-cost solutions and the most appropriate technologies.
- There is the need to raise local capital. This can possibly be done by subsidising interest, to reduce its cost.

D) What are the risks of involving domestic private sector?

This question was answered by turning the question around: “What are the benefits of involving an international operator”?

Both international and local companies are required and both need each other. International companies are needed for their management skills and knowledge transfer, and their ability to attract international finance. Local companies need to take over eventually, since they have the better link to the consumers.

4.3.2 Working Group 2: Opportunities and Risks of Opening Competition for Management Contracts to a Wider Array of Firms

The facilitator was Mr. Gerald Leopold of VA TECH WABAG, and the rapporteur was Mr. Dharman Suryanarayanan, of Ministry of Finance, France.

A general understanding was reached on the role and the triangular relationship among the major parties involved in PSP projects: the municipality is the client; the donor acts as financier, and increasingly also as project facilitator; the operator is the service provider. The following results were reported back to the plenary session:

A) Market potential involving smaller OECD operators, and potential benefits

A market potential for smaller operators exists; however, some difficulties need to be addressed. Operators have tended to focus mainly on management contracts, which means basically carrying out consulting services. New, smaller entrants certainly will prefer management contracts as being less risky than other types of arrangements. Municipalities, however, often are not interested in advice; they expect cash input to solve their problems. Thus a facilitator or mediator is needed to explain to the client that a step-by-step approach is important, and that good management performance is key to obtaining international financing.

The group discussed the option of involving new, smaller operators through a system called "portage," wherein a newcomer teams up with a larger or more established operator in the region and the market. This may be a good option when the market is limited because there are not enough projects.

B) Which measures are needed to open tenders to a larger array of companies?

Bid evaluation criteria play an important role in ensuring high quality services. However, evaluation criteria that are too stringent could be a barrier for smaller operators.

Donors could require experienced operators to cooperate with newcomers in order to ease their market access and gain operational experience. Municipalities would not be so happy if they were used as a testing ground for a new operator. They may have concerns that the newcomer would not do the job as professionally as a well-established operator.

Municipalities have also complained when staff assigned to the project do not comply with the initially requested expert profile, or when experts have been replaced after a short time. Improvements in the procurement design have been suggested to stop underbidding – in some types of contracts, even systematic underbidding.

Management contracts usually define the tools that operators must use in performing the contract. However, the operators' know-how is based on their own tools, and they should be given more flexibility to use them.

Blending private money and public grant money (subsidy) is not seen as wrong. But appropriate mechanisms have not been sufficiently developed to enable an efficient mixing of public and private funds. This relates especially to ISPA and cohesion funds.

5 LESSONS LEARNED, CONCLUSIONS, AND NEXT STEPS

This section summarizes the presentation by Mr. Motoo Konishi, Sector Manager, Infrastructure and Energy Services Department of the World Bank, reflecting lessons learned, conclusions, and recommendations.

- The easy projects have been taken up, and the private sector is running out of markets. Operators are retreating from providing financing and are focusing on operations (“... this is what we can and what we want to do ...”), and requesting the IFIs and donors to enlarge their financing portfolios. Operators are also calling for more stability and transparency in contract administration, and for IFIs and donors to mitigate risks. The use of Management Contracts is thus increasingly emerging as the preferred model.
- Three tiers of markets have been identified. The existing market forms the 1st tier EU accession countries, where little or no help is needed. The main driver in this market is EU legislation, to be adopted by these countries (*aquise communautaire*), with the support of EU grant financing instruments such as ISPA and SAPARD. However, the private sector claims that these financing tools have, to some extent, actually blocked the private sector from working in this market, since no practical procedures have been developed to combine EU grant money with private sector investments.
- Countries such as Turkey, Romania, Bulgaria, and the Balkans fall into the 2nd second tier of markets, where the private sector requests that IFIs and donors provide assistance in opening them up. Turkey is advanced in this process; a study on municipal sector reform, a water sector strategy, and the Iller Bank reform strategy, have all been completed and submitted for cabinet approval. The Government is prepared to invite the private sector for discussions.
- Countries where new markets still need to be created, such as Russia, Ukraine, and Kazakhstan, fall in the 3rd tier region. This requires corporate culture and behavioral changes, and communication about the technical, operational, financial, and management aspects of PSP. A critical mass of technicians and policymakers needs to understand modern utility methods. There is a proposal to establish a training center in Poland that will among other things address Public-Private Partnership issues, for FSU practitioners in the sector.
- Current efforts notwithstanding, public acceptance of PSP is still lacking, and improving the negative image will require transparency and good governance. Operators need to clean up their image.
- The private sector is retreating from financial engagements; their shareholders have become much more risk averse. Very limited funding is available from donors, including the World Bank, which will fund 16 operations totalling US\$960 million over the next 3 years. There will be much more selective and stringent targeting of funding in terms of developing PSP, and far better coordination among major donors and IFIs will be required.

- The private sector requests help in mitigating all risks not directly related to operations, such as currency risk, regulatory risk, payment risk, sub-sovereign risk, and affordability risk. However, IFIs and donors state that they cannot take on all these risks for the private sector. Therefore, choosing countries for PSP projects needs to be done very selectively.
- Private sector shows now considerably less interest in getting involved in concessions, and in bringing in fresh capital. There is a very limited appetite even for lease (*affermage*) contracts. Management contracts are now considered the safest way of entering into new markets. The World Bank will continue to support the use of Management Contracts, where appropriate, but risk mitigation cannot be done in a vacuum, or through institution building. Operators should be used as an instrument of change, but the Bank should play a more pro-active and upfront role in resolving differences.
- The interest in management contracts was confirmed by five operators, who say they represent the minimum risk. One firm expressed interest in a 100 percent performance-based leak reduction contract. Two firms expressed interest in lease contracts in the 1st tier accession countries, as well as in a medium-term engagement in Turkey. One company expressed interest in a long-term contract in Russia.
- Operators also discussed the possibility of amalgamating smaller cities into viable packages, and the need to lower the barriers to entry. Suitable procedures to combine output-based aid with private sector engagement should be developed and improved.
- The private sector also asked for more advanced Management Contracts, with control over personnel. Bank procurement requirements should be simplified, and the private sector would consider it advantageous to have IFI/donor grants and loans to accompany private sector lease and *affermage* contracts.
- Public awareness and acceptance of PSP is limited. Donors clearly stated that PSP is not a panacea, but one instrument among many, which they will use if it is the most appropriate solution.

Next Steps

- As a next step, the World Bank will enter into discussions with authorities in Turkey, followed by Bulgaria and Romania, to open up markets. Another task will be the creation of markets; one concrete approach is the establishment of a training center for the countries of the Former Soviet Union.
- The Bank will organize follow-up discussions on market development, including discussions to advance the concept of management contracts.

6 ANNEXES

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ANNEX B: PRESENTATIONS