

Consumers Pretend to Pay and Utilities Pretend to Supply Good Service: Breaking the Poor Performance Syndrome

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This article is the first in a series on the strengths and limitations of new regulatory institutions that can promote credibility to potential investors, legitimacy for consumers, and efficiency in infrastructure investment and operation. The author is Director of PURC and leads the development and delivery of the *PURC/World Bank International Training Program on Utility Regulation and Strategy*. Based on interactions with nearly 800 participants from 110 countries, a number of lessons have emerged from the ten course deliveries to date (www.purc.org)

There is no simple “solution” to the water problems faced in developing economies. However, problems can be managed more effectively if some oversight responsibility is assigned to an independent regulatory commission. This article highlights a fundamental issue regarding water sector reform facing nations today: how to constrain political opportunism. All stakeholders--equipment suppliers, multi-lateral agencies, water systems operators, customers, and government ministries--have an interest in improving the investment climate so nations can move forward to build and operate the water systems needed for the 21st century.

Compact Between Citizens and Water Utilities

The title of this article is a stylized version of what seems to be the implicit compact between citizens and water utilities in many emerging markets. The “unstated” compact (“Customers pretend to pay and utilities pretend to supply good service”) places problems onto the shoulders of future generations, and harms prospects for improved sector performance today. Customers pretend to pay for services in three ways: (1) by contributing to high rates of non-payment (where disconnection may be disallowed), (2) by paying non-sustainable prices (that do not even cover the operating costs of systems, let alone the capacity costs), and (3) by not recognizing groundwater depletion and salinity intrusion (opportunity costs that are seldom taken into account in the prices paid by today’s consumers). “Local control” has not necessarily meant good stewardship of this planet’s water resources; rather, it often contributes to poor sector performance.

Water utilities pretend to provide good service in the sense that stated national objectives and service requirements are seldom achieved. The poor performance may be due to political expediency or to severe economic constraints. In either case, citizens have a right to be disappointed. Even when disappointment turns to outrage, the pattern of under-performance is still unlikely to change. Clearly, inability to pay is part of the explanation for non-remunerative prices and inadequate investment. However, those

households lacking access to piped water connections actually pay high prices for the water they do consume (Walker *et al.* 2000). So poor performance stems from more than low per capita income.

This article reviews why the water sector in emerging markets continues to have a reputation for poor performance for citizens. Other articles in this series will examine how improved incentive mechanisms (using benchmarking comparisons), the introduction of better price signals and rate designs, and private participation in water/sewerage utilities can promote quality improvements and system expansion.

Problems with Local Control

Voices from around the world argue, “Water is ‘free’—part of our national patrimony. Local control is *essential* if citizens are to maintain jurisdiction over water resources.” Yet this stance runs totally counter to the requirements for obtaining external capital! Whether municipal bonds are issued to expand water systems or private capital is drawn directly into the sector, investors seek some insulation from volatile local politics. Analysts have examined how regulatory policies that promote uncertainty raise perceived risks for investors. For example, Emmons (2000) documents the role of predictable regulatory environments as a key element affecting investment. In addition, Henisz and Zerner (2001) demonstrate how systems of checks and balances provide more stable policy environments that promote network expansion.

Thus, policy-makers face a difficult choice: yield some local control in order to reduce the financial risk perceived by investors. Non-diversifiable risk is the key determinant of required returns on investment, and certainly one of the main factors affecting the price of delivered water. Of course, if scarce government funds can be diverted from education and health into investments in water/sewerage systems, the trade-off seems to disappear. Even then, however, thoughtful government officials would like some guarantees that funds will not go into expensive projects that line the pockets of the relatives of local politicians.

Lag in Private Participation due to Political Opportunism

According to a recent World Bank Report, approximately one-third of the world is living under moderate or severe water stress, with at least 19 countries dependent on foreign sources for more than 50 percent of their surface water. By 2050, the proportion of people living at or above moderate water stress could double (The World Bank, *Entering the 21st Century 1999/2000*). In developing countries, water problems will not abate to any appreciable degree unless large infusions of private capital are committed to potable water and sanitation projects. Multilateral funds and public subsidies cannot fill the gap. Private water projects reaching financial closure in such countries increased tenfold between 1990 and 1997. However, private involvement is still small relative to public involvement in that sector and to private participation in other infrastructure sectors, particularly energy (Silva *et al.*, 1999).

In large part, the lag in private participation is due to a higher degree of governmental opportunism and politicization of water pricing and operations. In their careful set of case studies, *Spilled Water*, Savedoff and Spiller (1999) note how water is frequently considered a social commodity; there is considerable political pressure to provide water and sewerage services at below-cost prices to consumers. If a government agency sets prices below a water utility's ability to cover its costs -- much less generate any return on investment -- the utility will not be able to finance upgrades to its delivery or treatment network. Political horizons may be short term but the development of an adequate water infrastructure requires long-term investment commitments that extend far beyond the next election. Developing countries face particularly acute challenges with respect to expansion of capacity and distribution systems and improvement in service efficiency, including reduced levels of unaccounted-for water.

Savedoff and Spiller identify the poor performance of water systems as involving what they call a "low-level equilibrium"—the title of this paper just provides a more dramatic way of characterizing the dysfunctional systems that have evolved. In the case of Latin America, nearly 1 percent of annual gross domestic product has been invested in the water sector during the past decade: yet coverage and quality remain low. These analysts argue that the political economy of the sector results in governments behaving opportunistically, companies operating inefficiently, and the public withholding funds from the sector. The fundamental problem is credibility of government commitments—if it is absent, long-term investments will, in fact, not be made.

Requirements of New Regulatory Frameworks

Private investments will not be forthcoming to address citizens' needs unless certain conditions exist to ensure investors that a credible regulatory framework is in place that:

- ? provides utilities with incentives to expand capacity and improve quality;
- ? assures investors that the regulatory process is fair and open (transparent) to all parties and equitable in its application; and
- ? promotes predictability, so that all stakeholders understand the basis for pricing and investment decisions.

In a growing number of developing countries, independent regulatory commissions (IRCs) have been established to: replace short-term political opportunism with professionalism and expertise; promote transparency and the informed involvement of stakeholder groups; balance the legitimate interests of elected government officials, customers receiving service (and citizens without service), and investors; and provide water utilities with strong incentives for efficient performance.

Training for Regulatory Professionals

The PURC/World Bank course attempts to promote professionalism and the application of best-practice principles in regulatory agencies. This training program provides an international forum where attendees learn from each other—from their success stories as well as failures. Participants work hard trying to find solutions to improve infrastructure, setting aside regional political rivalries for two weeks. The feedback indicates that attendees leave with technical tools and analytical frameworks that can help them create a sustainable regulatory environment in their home countries. That, in turn, means cleaner water and better access to water.

In the “Florida Course” (the informal name given by participants), attendees learn that all countries have very different starting places, but are dealing with common issues. Some are in early stages of development, with very basic or non-existent infrastructures, while others are developed, but are moving away from governmental control. Being able to share cross-country and cross-sectoral experience and learn how to translate principles into practice is essential if regulation is to promote efficiency and fairness. No training course can provide a simple “solution” to the water problems faced in developing economies. However, political opportunism can be attacked and problems can be managed more effectively if some oversight responsibility is assigned to well-trained professionals in an independent regulatory commission.

If customers really want to pay for water services and not only pretend to do so, nations must support the development of new independent regulatory institutions. Funding the agency, selecting leaders with outstanding credentials, and recruiting a strong staff of professionals are initial steps towards creating a regulatory climate that can break the poor performance syndrome (Berg, 2001).

References

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