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Lessons from the Guinea Water Lease

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Until the late 1980s Guinea had one of the least developed urban water supply sectors in West Africa. Less than 40 percent of urban dwellers had access to piped water through either connections or standpipes. Where connections existed, service was often interrupted and water treatment inadequate. To improve this situation, the government of Guinea in 1989 entered into a lease arrangement for private sector operation of water services in the capital city, Conakry, and sixteen other cities and towns.[1]

Two organizations are central to the lease arrangement: a state-owned national water authority, Société Nationale des Eaux de Guinée (SONEG), and a water management company, Société d'Exploitation des Eaux de Guinée (SEEG). SONEG owns the water supply facilities in the cities and towns covered by the lease. It is responsible for sector development, including planning and implementing new investments, and for servicing sector debt. SONEG also has responsibility for setting tariffs. SEEG is jointly owned by the state (49 percent) and a foreign private consortium (51 percent). SEEG holds a ten-year lease contract with SONEG under which it is responsible for operating and maintaining urban water supply facilities, billing customers, and collecting charges. The private partner provides management services to SEEG through a separate management contract. At the start of the lease the consumer tariff was raised from US$0.12 to US$0.25 per cubic meter. This tariff was still too low to cover operating and debt servicing costs, so in the initial years of the lease the difference between tariff revenues and costs was funded by an International Development Association (IDA) credit. This subsidy has declined stepwise as tariffs have increased.[2]

By 1996 connections had increased from about 12,000 to more than 23,000. Metering has increased from about 5 percent to 98 percent for private customers, and to 100 percent for government customers. Investments in new supply capacity (external to the lease), combined with rehabilitation and maintenance, have brought about a substantial increase in the population with access to safe water, from 38 percent in 1989 to 47 percent in 1996. And with progressive tariff increases, the average tariff (US$0.83 per cubic meter in 1997) now more than covers costs. SEEG's water revenues (excluding the subsidy) rose tenfold between 1989 and 1996. In an environment in which earlier attempts to secure reliable access to safe water had foundered, and in which financial sustainability had seemed unreachable, these achievements are truly impressive.

Ongoing issues and problems

Despite these gains, two broad concerns arise about the performance of Guinea's lease contract. First, the water supply system, particularly in Conakry, has not improved and expanded as fast as had been hoped. Unaccounted-for water remains high, at about 47 percent. New connections to the system have been added slowly—though the lease did not specify targets. Second, the relationship between SONEG and SEEG has not been smooth, lessening the efficacy of SONEG's monitoring and regulation.

Physical progress

Both SEEG and SONEG have some capability to influence the rate of new connections and of reduction in unaccounted-for water. But each tends to blame slow progress on failures by the other. For example, SONEG attributes the slow pace of new connections to SEEG's reluctance to make connections from existing extensions to the network, while SEEG argues that much of the demand for new connections is in areas where SONEG has yet to invest in network extensions. For unaccounted-for water, SONEG's slowness in procuring rehabilitation works is probably a factor, but SEEG's incentives to reduce losses have almost certainly been weakened by its low production costs. Commercial losses are rising as tariff increases lead to more defaults on bills and stronger incentives for illegal connections. In 1996 58 percent of private bills went unpaid. Nonpayment by government departments has also been a major problem, particularly in the early years of the contract. (At the beginning of the contract the government accounted for more than 50 percent of all billings. By 1996 this share had dropped to 30 percent, but government arrears remained a significant issue.)

Attempts to improve coordination between SEEG and SONEG are unlikely to resolve concerns about unaccounted-for water and new connections. The coordination of new investment with operations and maintenance will remain problematic as long as commercial risks are shared between the two entities and SONEG remains the principal financier of works that contribute to SEEG's effectiveness as an operator. The problem is further aggravated by a lack of clear separation between SEEG's activities as an operator, for which it theoretically bears some commercial risk, and its activities as a service contractor to SONEG for rehabilitation and extension works, which are performed on a cost-plus basis.

Institutional efficacy

Lease contracts require a high level of administrative capacity, and solid political will to enforce their letter and spirit. They are not necessarily easier to administer and regulate than contracts for more fully fledged private sector involvement, such as concessions. A lease may be simpler to administer than a concession because the administrator does not need to define or monitor investments by the lessee. But leases require coordination and the allocation of commercial risk between the government, as investor, and the private sector, as operator.

In Guinea the government has had limited success in bringing clear commercial incentives to bear on the private company in its operational and maintenance roles. Weakness in SONEG's monitoring of SEEG could have broad repercussions. For example, without adequate reporting and monitoring, SONEG will have difficulty assessing the soundness of SEEG's requests for increases in the overall tariff and in its share. To the extent that SONEG responds passively to proposals from SEEG for tariff increases, SEEG's commercial risk is lessened. At the limit, if the tariff is set on a cost-plus basis, the lease will approximate a management contract (and one without specific performance targets and enforcement mechanisms) and commercial risk will be borne exclusively by the government. (In practice, tariffs have risen steadily. Average tariffs are now high by the standards not only of developing countries, but also of industrial countries.)

A second cost of weak monitoring and enforcement is a reduced capacity to enforce separation between SEEG's extension and rehabilitation activities and its operational activities. For example, where monitoring is weak, financial transfers between activities putatively subject to commercial risk and those performed on a cost-plus basis might go undetected. Again, the result could be a reduced capacity by SONEG to control its commercial risk.

Lessons

The Guinea lease represents an innovative, broadly successful attempt to draw on the strengths of the private sector to improve water services. It would be unfair and inappropriate to use hindsight to criticize arrangements that are a major advance over earlier attempts to improve water service delivery in low-income countries and that have produced real gains for consumers. But hindsight can provide guidance for ongoing improvements in Guinea and for future projects in other countries. Many low-income countries, from the transition economies of Central Europe to African nations such as Angola and Mozambique, share Guinea's problems in improving water services. Improving and expanding service requires large investments. The government's capacity to undertake the required investments directly or to oversee their implementation is limited. Passing as much investment responsibility to the private sector as possible—as soon as possible—is thus highly desirable.

Private companies, however, have been assumed to be unwilling to make large investment commitments in the water sector in very poor developing economies. Water sector assets amortize over long periods and have little or no resale value. Where capital markets are underdeveloped, investors who want to sell out may have limited ability to dispose of their shares. On top of this, the water sector is prone to government intervention. In this kind of environment the credibility of the government as a long-term contractual partner, regulator, or both is critical to the willingness of private companies to invest in the sector, and to the price tag that the private sector will, one way or another, place on its involvement.

Guinea sought to resolve these problems by introducing private sector involvement and commercializing the water business in a gradual, stepwise manner. Using a lease arrangement, rather than a full-fledged concession or asset sale, meant that the private sector was not required to commit any investment funds. Using an IDA credit to smooth the process of tariff increases meant that the operating business could function on a quasi-commercial basis from the beginning. The government's minority share in the operating company presumably gave assurances that there would be some local sharing in the benefits of commercialization, beyond the benefits from improved services. The expected benefits were twofold: early and lasting gains in the availability of services and the efficiency of service delivery and, in the medium term, the creation of an environment more attractive to private investment and risk taking.

The Guinean approach, while producing important gains, has not worked out exactly as planned. The risk sharing implied by a stepwise process has proved difficult to implement and enforce, with the result that gains to consumers have been less than hoped for and much suspicion remains between the public and private sectors. The question then arises as to what other countries might do to replicate the gains of the Guinean approach while avoiding some of its shortcomings. Two broad options present themselves: privatization by less ambitious steps than were attempted in Guinea, or an altogether bolder, larger step toward privatization.

Privatization in small steps

The key to an effective gradual move to private participation is a realistic and enforceable allocation of functions and risks between the parties at each stage in the process. This allocation should accord with the parties' comparative advantages in performing the functions and managing the risks. For example, if exposure to commercial risk is the primary source of performance incentives for a private partner, that risk should be borne by the private partner. If the private partner is unwilling to take on any substantial commercial risk, a lease or a concession should be abandoned in favor of a management contract with a few, largely indisputable, performance targets (as is proposed, for example, for Angola).

If government agencies lack the capacity to monitor and enforce contracts with the private sector, the factors to be monitored should be as simple as possible. This again favors a management contract over a lease. Industrial country blueprints for regulatory structures and functions should be avoided in favor of careful analysis of the minimum administrative and regulatory functions required, and of the comparative advantage of different agencies in performing these functions without undue political interference. One option is to contract out parts of the monitoring function to private sector auditors.

If investment needs are substantial and require some contribution of government (or multilateral) funds, the contractual arrangement chosen should be cognizant of the tradeoff between the costs of relatively inefficient government administration of investments and the risks of contracting with the private sector to administer investments it does not fund. If investment responsibility is passed to the private sector, relatively sophisticated monitoring may be required to control profit transfers between investment and operational activities and to minimize gold-plating. Realistically, the private partner must be expected to take some rents. Monitoring will not eliminate these rents, but it can help keep them within socially acceptable bounds.

Is a big jump better—or even possible?

Two arguments might be made for a stepwise approach to private sector participation. First, a stepwise process may be necessary in poor developing countries if no reputable private company is willing to invest in the water sector. Second, a stepwise process may improve the terms of private sector involvement from the perspective of consumers.

The first argument can be put to a market test. A likely result in many low-income countries is that no experienced private water company will take on full operational and investment responsibilities unless it is paid to do so, because of the high risk. Such a payment may well be politically infeasible. Still, the need to subsidize entry does not in itself mean that a stepwise process would be objectively better than a "big jump." A negative valuation of a water company by private bidders might reflect a compound of expectations and risk assessments—about the relationship between the tariffs that the government would likely allow and the costs of establishing a reasonable level of service, about the uncertainty over the government's future regulatory behavior, and about the salability of the private company's stake. Thus, to secure a positive price, the government might need to take actions ranging from intensive information gathering on the state of existing assets, to the establishment of a credible regulatory authority, to the development of passably liquid domestic debt and equity markets. The question that then must be asked is whether the benefits of these actions exceed their combined costs and the costs imposed by delays in mobilizing the incentives for the private sector to improve efficiency. Welfare might be increased more by immediate, full privatization, even if that requires a subsidy, than by postponing privatization while using various government instruments to make things better. Full private involvement is likely to bring larger and more immediate welfare gains, for example, if the private partner is in a better position than the government to rapidly improve and use information about the utility's physical and commercial status or to develop risk management programs. Such an approach may never be politically attractive, but it is an alternative that should be recognized whenever gradualism is advocated.

In arguments for gradualism in involving the private sector in water, there is an implicit tendency to gamble more on the likely benefits of government initiatives than on the likely benefits of private ones. Policy advisers have traditionally been more concerned about private sector rent seeking at the expense of customers than about the costs, failures, or rent-seeking activities of government utilities. In practice, the most feasible and least risky strategy is rarely that which relies least on the private sector. Market testing of the kinds of deals that the private sector is prepared to take on, and of their price, is essential in continuing to identify the best options for the neediest countries.

[1] Lease arrangements are discussed by Pierre Guislain and Michel Kerf in "Concessions—The Way to Privatize Infrastructure Sector Monopolies" (*Public Policy for the Private Sector,* September 1995).

[2] Thelma Triche, "Private Participation in the Delivery of Guinea's Water Supply Services" (Policy Research Working Paper 477, World Bank, Washington, D.C., 1990).

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