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Utility Restructuring Corporatization Decentralization Performance Contracts: Power Line

Approaches to Utility Reform

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Below are descriptions of different models of sector reform and useful links:

A government considering ways of improving performance in its utilities may seek to achieve this by involving the private sector through one the forms of PPP Project discussed in Agreements.

Involving the private sector may, however, not be possible, practical or desirable, as is discussed in Government Objectives.

In such cases the government will need to consider whether it can improve performance through sector reform or restructuring. This may be as a first step towards involving the private sector, once assets have been ring-fenced and performance standards established, or it may be a solution in itself.

Features of a Well-Run Utility

The features that often define a well-run utility, whether fully public or one with some private sector involvement, include:

- **Operational Autonomy.** Being independent to operate professionally in the interests of all stakeholders, without arbitrary interference by others.
- **Financial Autonomy and Clear Reliable Funding Sources.** Tariff policy that reflects economic cost of service provided, as well as clear and reliable subsidy mechanisms.
- **Accountability.** Being answerable to another party for policy decisions, for the use of resources and for performance.
- **Customer orientation.** Reporting and listening to clients.
- **Market orientation.** Making greater use of markets and introduction of market-style incentives.
- **Transparency.** Preparing accounts for independent audit to reflect true costs of operations.

When a public utility is not performing well, it is difficult to make recommendations for reform unless and until it has clearly defined incentive and management reporting structures and a separate budget. A utility may be part of a larger government ministry or local government structure, with pooled funding and accounting. In some cases, workforces may even be combined with other municipal services or utilities.

In order to establish how a utility is performing, it is necessary to separate the assets, liabilities, workforce, costs and revenues attributed to that service. Described below are the more common forms of utility reforms that all involve some degree of identification of costs and revenues.

It is possible to have utility reforms that fall short of restructuring, and contain features of utility restructuring. However, if there is no separation and clarity of reporting and management lines from other utilities, parts of a ministry or municipality, then any reforms are likely to have little or short-lived impact. For more on the different forms of Utility Reform, go to World Bank Presentation on Reform of Public Utilities.

Utility Reform

The aim of utility reform is to create transparency in all the areas listed above and to allow accountability to stakeholders. The most modest method of reform would be to improve the management processes by:

- creating a performance plan with measurable deliverables or creating a performance contract between the utility and the municipality or relevant agency;
- creating a structure for monitoring performance, separate from the municipality;
- creating incentives for management to meet and out-perform performance plan, such as bonuses;
- institutional capacity building—training management to meet performance standards, out-perform, recruiting new or additional management with relevant expertise;
- enhanced customer involvement and attention to customer concerns.

While these reforms may make modest improvements, it is unlikely that they are going to be dramatic or enduring as the management will not have real accountability and there will be little transparency if there is no separate accounting and reporting structure.

Further reading:

- Public Utility Reform: What Lessons Can We Learn from IEG Evaluations in the Energy and Water Sectors?
- A Benchmark for the Performance of State-Owned Water Utilities in the Caribbean
- Key Topics in Public Water Utility Reform (2008)

Utility Restructuring into Separate Reporting Unit

Where there is a desire to create greater transparency, while keeping the utility within the larger department or municipality, a solution is to restructure the Utility into its own separate reporting unit. This involves:

- creating a separate unit within the municipality or department;
- with workforce specifically allocated to the unit;
- separate accounts drawn up for the utility with clearly defined budget allocation and greater transparency regarding actual costs of operation;
- allocation of portion of municipal debt (if appropriate) and cost of servicing that debt;
- allocating a portion of revenues (if any) to that service;
- creating a clear reporting structure.

This is often used as a first step towards greater autonomy or introduction of private sector. Separating the cost, reporting and accounting base of the utility allows the utility to build up a transparent operating history, with a more accurate cost base. However, the disadvantages with this system include:

- difficulty with creating completely separate management reporting lines;
- difficulty in achieving enduring promises of separate budget allocation from within government.

Further reading: Some Options for improving the Governance of State Owned Electricity Utilities
Characteristics of Well Performing Water Utilities

Corporatization

A more enduring model of reform is to transfer assets and liabilities, staff and the ongoing business of the utility into a corporation. This is known as "Corporatization". The entity would have a separate shareholding, board of directors and accounting and reporting lines. It may also be helpful as a first step towards private sector involvement. It is a process similar to this that was followed prior to Privatization in a number of jurisdictions.

Corporatization — Key Features

Corporatization has the following key features:

- **Separate legal entity.** The organization is legally established as an independent entity and hence the transfer of control is more durable than under utility reform.
- **Managerial autonomy.** Management has virtually complete control over all inputs and issues related to production of services.
- **Transparency and reporting.** The utility is likely to become subject to prevailing company law and accounting rules in the country.
- **Assets and Liabilities.** the corporatized utility will have transferred to it the assets and liabilities appropriate for it to perform its functions and to be viable. It may be that it is inappropriate to transfer all existing debt associated with the service to the corporatized entity if the utility is unlikely to be able to raise revenues to service the debt and fund existing operations. If a government wants a flourishing utility post-corporatization, it may have to assume or right off a substantial proportion of such debts. Assets and liabilities should also be correctly valued to avoid allegations (particularly if any part of the entity is divested at a later date) that there has been an undervalue, or public property is being given away, etc.). One element of assets which can prove contentious is what to do with receivables, particularly those owed by public entities. A sensible bad debts policy needs to be adopted with only those receivable which have a realistic possibility of recovery being transferred to the new entity.
- **Public law and private law.** In many countries public entities are subject to a body of law and court system known as administrative law and the administrative courts, which is different from that applicable to private citizens and companies. Corporatization of a utility may result in the utility becoming subject to private law - this is not always the case, however, even where the utility is incorporated into a limited liability company as it may still be deemed to be providing a "public service" and so the position should be verified with local counsel.
- **Board of directors.** will represent shareholder interests but will also have fiduciary duties to the utility's wellbeing and potentially to other stakeholders such as customers and creditors.
- **Staffing.** It may be possible for the utility to follow different recruiting and staffing rules from the civil service rules, allowing for workforce benefits such as performance incentives and bonuses, together with more flexibility on hiring of staff and disciplinary procedures. Care will need to be taken to ensure that any increase in salary is linked to improvements in performance. Redundancy law issues regarding public employees will need to be taken into account. Any benefits currently available to staff will need to be examined to determine how these can be transferred. In the case of pensions, care will need to be taken regarding any pensions fund that has been built up and what liabilities are being transferred.
- **Independent status.** Includes a hard budget constraint or financial "bottom line"—which makes the organization fully accountable for its financial performance—with liquidation at least theoretically being the final solution in case of insolvency.
- **Greater financial independence.** Need to combine corporatization with reforms allowing for increased portion of revenue coming from sales (rather than budget allocation), increased possibilities for keeping and using extra revenue, as well as a hard budget constraint: allowing company to retain excess revenues, but is also making it responsible for losses.

Corporatization — Checklist of Issues

Below is a checklist of issues to consider when contemplating corporatization:

- Is new entity to be separate legal entity or just separate unit of existing utility or municipality?
- What assets and liabilities are to be transferred? Will new entity be required to pay for or account for these assets? If so, how will assets be valued? Are receivables to be transferred.
- Existing contracts with third parties—will these need to be novated or transferred?

- Will entity be subject to civil service employment rules? Is it possible to give performance incentives to employees? What are rules regarding transfer and redundancy of staff? What is to happen regarding benefits, especially pensions?
- Will there be a performance contract between entity and utility—will this be enforceable?
- Where will entity get its revenues—from end users or government grant, etc.?
- Are tariffs or revenues from customers sufficient to sustain cost of operations and costs of improvements? If not, will there be subsidies—if so, who will supply subsidies?
- Will new entity be a public or private law entity?

Corporatization — Lessons Learnt

Corporatization has been adopted in a number of countries. Lessons learnt from corporatization in different sectors around the world show that it must be carefully tailored to the situation in order to be effective in meeting the government's goals: [1]

- Organizational reform must directly and contemporaneously address labor issues—you cannot leave labor for later. Many of the most serious efficiency and performance problems are rooted here. For more, click on Labor Issues.
- Institutional innovations can allow organizational reform to be applied to new areas. Unbundling can enable market forces to be brought to bear in many areas previously thought to be natural monopolies. For example, concessions can create competition “for the market” when competition in the market is not possible.
- Intermediate reforms of autonomization and corporatization are more institutionally intensive—they imply a more sophisticated role for government—because government must utilize indirect disciplining forces rather than simpler instruments of direct control (as in a budgetary organization) or market forces (as in a privatized organization).
- A supportive external competitive environment must accompany reforms in internal incentives. If this environment is not present, systemic reforms may have to be implemented before organizational reforms can work.

[1] Innovations in Health Service Delivery : The Corporatization of Public Hospitals / Alexander S. Preker, April Harding, editors

Aggregation

Aggregation is defined as the grouping of several municipalities into a single administrative structure for the provision of a particular service. The main driver for aggregation is usually the potential to realize economies of scale by providing services to a larger customer base and therefore to render services more efficiently and at a lower cost. Another driver is to attract funding for projects for which one of the entities on its own would be unlikely to be able to raise funds.

Aggregation has been used most commonly in relation to raise finance for water and wastewater services, where it often makes sense to pool resources and assets, such as reservoirs. In countries with developed local bond markets exist, local authorities and utilities have combined together to raise finance for building jointly-owned infrastructure.

Aggregated structures can vary greatly, but are usually based on one of the following:

- Scale. Aggregated structures may group two neighboring municipalities, or several municipalities in a single region or across a broader territory.
- Scope. Aggregated structures may provide a single service (for example, bulk water supply) or all services. For each of these services, the aggregated entity may carry out certain functions only (such as procurement) or be responsible for all functions, from operations and maintenance to investment and

financing.
- Process. Municipalities may form aggregated structures voluntarily based on mutual interests, or, under instruction from a higher level of government, which, driven by the overall public interest, may impose or incentivize the aggregation process. The aggregation may be temporary (for a short-term specific purpose) or permanent.

There is potential, however, in aggregation for conflict between the parties if rights and obligations of each entity are not clearly established. It must also be emphasized that investments in infrastructure are long-term and that any relationship that is brokered for aggregation purposes will need to be enduring and flexible. These will be issues of concern for any funding institution as the success of the project will depend largely on the entities working towards common goals.

For more discussion on aggregation and to explore 14 case studies spanning various geographies, go to

- Aggregation Toolkit, World Bank
- Models of Aggregation for Water and Sanitation Provision
- Global Study on the Aggregation of Water Supply and Sanitation Utilities

Contract Plans & Performance Contracts

Whatever model of reform that is chosen for reforming public utilities, it has been found that these reforms can be made more effective if there is a performance contract in place between the utility and the government or regulator with incentives to meet and outperform that plan. This performance plan may be included in an informal Performance Contract, Contract Plan or a more formal, legally binding intergovernmental loan or grant agreement. Find more

Bulk Supply Contracts

Find sample raw or treated water bulk supply agreements between neighboring utilities or counties, as well as further reading materials on the topic here.

Further Reading

- How to Measure Decentralization: A Summary of the Global Literature Review on Decentralization Measurement (2024)
- Rethinking Power Sector Reform in the Developing World (2019)
- Key Topics in Public Water Utility Reform (2008)
- Ways to improve water services by making utilities accountable (2008)
- OECD Guidelines on Corporate Governance of State-owned Enterprises (pdf)
- Characteristics of Well Performing Water Utilities (pdf)
- Models of Aggregation for Water and Sanitation Provision
- Using a Private Operator to Establish a Corporatized Public Water Utility: The Management Contract for Johannesburg Water
- Performance Based Contracts in the Road Sector: Towards Improved Efficiency in the Management of Maintenance and Rehabilitation, Brazil's Experience

Related Content

- Contracts & Agreements

- **Approaches to Utility Reform**
- **Civil Works and Service Contracts**
- **Structuring Management, Operation and Maintenance Services**
- **Leases and Affermage Contracts**
- **Concessions Build-Operate-Transfer (BOT) and Design-Build-Operate (DBO) Projects**
- **Joint Ventures and Government Shareholding in Project Companies**
- **Full Divestiture and Privatization**
- **Performance Contracts**
- **Standardized Agreements, Bidding Documents and Guidance Manuals**

Additional Resources

- Power and Renewable Energy PPPs
- Sub-national and Municipal PPPs
- Telecommunications / Information & Communication Technology PPPs
- Public-Private Partnerships for Transport
- Water & Sanitation PPPs

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