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Regulation by Contract signing

Regulation by Contract

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Regulation by contract uses no separate regulatory agency, and the public sector asset holder to a contract monitors the performance of the operator (usually private but sometimes public). A contract typically defines the relationship between the asset owner and the service provider. France is a country with a long history of PSPs contracting with local government. Such arrangements are also in place in Metro Manila, and they are being used increasingly for public utilities through performance contracts in France, Germany, and Uganda. In some cases, third party approvals (for instance, from parliament or a government agency) are required for changes in tariffs.

While the terms and conditions of contracts are standardized to some extent, regulation by contract has been criticized for allowing tariffs to be determined on a case-by-case basis. In France, for example, in spite of the standardization of terms by the association of mayors for *affermage* contracts, significant differences in the tariffs allowed in different communes have triggered calls for some standardization in tariff-setting methodology and national economic regulation. Such proposals are fiercely opposed by communes and the private sector.

The range of contracts and arrangements available in France and Germany illustrate a number of models that can be applied to the circumstances of particular utilities, with more or less financing and investment risk passed to the private sector, depending on the contract. Mixed ownership companies are also used.

In France, regulation by contract has worked effectively with policies promoting aggregation of water operations, with incentives for communes to form clusters to delegate services to PSPs. Consolidation has also been significant among the private sector service providers (with three main water companies—now international providers—dominating the sector). This has been cause for concern, as these companies are well resourced and sophisticated, and their negotiating power is often considered greater than that of the communes.

Drinking water quality and environmental standards are typically monitored at the state or national level, but benchmarking of service providers is limited, and data are not always widely distributed or published.

Regulation by contract also enables municipalities to enforce sanctions against service providers directly, which achieves accountability at the local level. Administrative courts may also step in, particularly in France, to ensure both the public and private parties are carrying out their contractual obligations.

In France and Germany, regulation by contract is restricted to private operators, which limits the oversight to which public utilities are subject; as a result, public providers tend to have lower tariffs but also lower performance levels. Uganda has developed an effective system of performance contracts for public service providers. The system’s workability is generally attributed to significant government support and consistent policies, however, which might make it difficult to replicate elsewhere.

Table below summarizes the advantages and disadvantages of regulation by contract.

Table Advantages and Disadvantages of Regulation by Contract

Advantages	Disadvantages

Clear separation of policy function (at the national level) and asset ownership and oversight function (at the municipal level)	Limited regulatory oversight of public operators
Performance overseen by local entity (municipality)	Limited capacity of some municipalities
Aggregation of services of communes (achieving economies of scale) encouraged in France through legislation, with some aggregation achieved along river basins through clustering of delegated contracts	Fragmentation of sector in Germany, which has no policy encouraging aggregation through clustering of contracts
	Inconsistency in tariffs due to lack of central body setting tariff methodology
	Only private sector operators covered by regulation (in France and Germany)
Limited standardization of contracts	Inconsistency in enforcement of contracts
Flexibility of contracts, which can be amended, with courts making determinations on changes of circumstance	Continued lack of transparency in award and extension of contracts (particularly in France, where three private operators dominate the market, which may reduce room for effective competition)
Sanctions and incentives through contracts, with municipalities having ultimate sanction of termination	Limited disclosure of information and little benchmarking of private operators
Equilibrium between parties, and performance of contractual obligations by both ensured by administrative courts	
Some obligations under law for disclosure of information	Few contracts (concessions) where private sector is investing heavily
Extensive private sector participation (in France)	

Examples

This section looks at this mechanism and highlights France and Germany, where private participation in the water sector typically takes place through contracts for delegated services. In each of these countries, economic regulation is through the contract and carried out by the municipality or local government. Public sector water providers are typically self-regulated, although Germany is moving toward their corporatization. Uganda is a country where the regulation by contract is mainly of the pubilc service provider.

- France
- Germany
- Uganda

France

The legal framework for the water sector is set out in two main laws in France: the Water Law of January 3, 1992, and the Water and Aquatic Law of December 30, 2006.

Local governments (communes) have been responsible for provision of water and sanitation services since the French Revolution in 1789, and the system of oversight and regulation has evolved over time. France is divided into twenty-two administrative regions (including Corsica), which are subdivided into ninety-six departments, each of which is administered by an elected general council. The departments are further subdivided into a total of about 36,000 local communes, each with an elected municipal council. These municipalities have powers for ensuring public order, security, and health. Water and wastewater services are a municipal responsibility. The communes either manage the water services themselves or enter into

contracts to delegate them to private companies. To manage some of this fragmentation and achieve some economies of scale, organization of water and sewerage services is often carried out intercommunally—that is, several communes work jointly to provide or share the services, with the arrangements ranging from a single-function syndicate (*syndicat d'eau*) to more extensive aggregated structures. While this aggregation is not obligatory, it is actively encouraged, and the so-called "*Chevèment*Law" of 1999 created an enabling environment for aggregation with clear models for intermunicipal cooperation, including accepted rules on governing structures, entry and exit, tariff setting, and asset transfers (ERM 2005). A syndicate may manage provision of water resources by itself or contract out to a private company. Many communes have aggregated some functions to create economies of scale or, indeed, around a river basin (as is the case with the Syndicat des Eaux du Bas-Rhine, which is aggregated around the Rhine River Basin).

Delegated Contracts

The first delegated contract in the water sector was signed in 1856, and delegation is now used extensively; as of 2011, only 21 percent of France's population received water through publicly managed utilities (Aubin and Varone 2007). Some cities have, however, been looking to bring services back under public management—Grenoble did so in the 1990s, and, more recently, part of the municipality of Paris has. The private sector is dominated by three large French water companies: Lyonnaise des Eaux, Generale des Eaux (Veolia), and SAUR.

Three forms of delegated contract are signed between communes and private companies—the management contract, the *affermage* (lease) contract, and the concession—and they have been adapted over the years to meet the changing challenges of the twentieth and twenty-first centuries. As France is a civil law jurisdiction, a number of provisions are implied by law in the contract or are required of the contract (such as limitation of its duration, requirement for separate contracts for water and sanitation services, or obligation to procure the contract competitively). As delegated service contracts, they are subject to administrative law and administrative courts, which have developed jurisprudence over the years on how to interpret them. In practice, the administrative courts play an important role in ensuring that both the public and private parties carry out their contractual obligations.

Management contractsare typically for a period of five years and fall into two main categories:

- *Gérance*is an operation and maintenance (O&M) contract. The private operator provides the staff and expertise required to run the system but is not required to provide working capital or investment funds. The operator is paid a fixed fee.
- *Régie intéressée*is similar to *gérance*, but the operator's payment is based in full or in part on measurable results—in other words, it is a form of performance contract.

Affermage contractsare signed for ten to fifteen years and account for approximately 88 percent of all delegated contracts in France. Typically, the private operator is responsible for operation and maintenance of the system and also for asset maintenance and some renewals and rehabilitation. The operator usually collects tariffs and is paid a fee from those tariffs (which may take the form of percentage of revenue), then pays the rest of the revenue to the commune, which puts it toward investment in asset rehabilitation, renewal and expansion, and cost of depreciation.

With concessions, which are signed for twenty to thirty years, the private operator is responsible for financing new investment in the network and treatment facilities over the life of the contract. The assets are still owned by the commune, and the operator takes full end-user collection risk.

Communes: Tariff Setting and Oversight of Performance

The main regulatory functions—contract monitoring and tariff setting—are carried out by the communes through regulation by contract. In the case of aggregated services, the communes will have an agreement on tariff setting and oversight of the contract. Tariff setting is implemented through contracts signed by

municipalities with the local private partners. These have provisions for review of key contractual provisions and are based on a concept of “economic equilibrium” (which is supported by jurisprudence and rigorously enforced by the courts), whereby the parties should be kept in the financial position that was contemplated at the beginning of the contract.

Where the communes manage the water and sewerage provision themselves, they are self-regulating and subject to only limited oversight, as discussed below.

National, Regional, and Local Oversight

Communes are not completely free to formulate the terms and conditions for their contracts. The French government sets standards for drinking water quality through the Ministry of Health and the General Health Directorate, which implement standards set by the European Union. The government requires competitive tendering of contracts through the Competition and Consumer General Directorate and has imposed statutory limitations on the duration of the contracts—for instance, *affermages* and concessions may not be for more than twenty years. Contracts for water and sanitation services must be kept separate. Less formal guidance and standard terms are also offered by the association of mayors of France, which has developed model forms of *affermages*.

At the national level, water and sanitation policies are determined by the Ministry of Environment, Energy, Sustainable Development, and Territorial Planning; the Ministry of Health (with regard to drinking water); the Ministry of Interior (which supervises the local governments); and the Ministry of Economy and Finance (which, together with the Ministry of Environment, supervises the regional water agencies).

The water directorate is called the National Office for Water and the Marine Environment–Onema and isa part of the Ministry of Environment. It provides policy advice to the government and supervises the regional water agencies (*agences d’eau*) and divisions of the French Department of Ecology, Sustainability, Transportation, and Housing, which were established in 1964 along river catchment basins (Adour-Garonne, Artois-Picardie, Rhin Meuse, Loire Bretagne, Rhône-Méditeranée, Seine-Normandie, and Corsica). The directorate has, therefore, a relatively localized presence and significant capacity to provide support and advice to the communes, whose main functions are to oversee and manage water sources and resources, developeffective management schemes, and reduce pollution and createhealthier local environments. As the water agencies are organized along catchment basins, they are not based on regular administrative boundaries. Within each agency, a water basin committee collaborates with neighboring communities and even other countries to help manage the area’s aquifers, oversee resource allocation, and create long-term water management plans. The committees represent and protect a diversity of interests. Locally elected representatives comprise 40 percent of their members, 40 percent are local water users, and 20 percent are federal government representatives.

At the commune level, several agencies are responsible for ensuring compliance with national water laws. In addition to the commune itself, the Department of Sanitary and Social Issues is responsible for monitoring and enforcing national standards for drinking water quality and monitoring social issues related to the water sector, such as access by poor consumers. The Department of Equipment under the Environmental Prefectures Office of the Department of Agriculture and Forests has responsibilities related to water resources, such as environmental regulation, planning, and water use.

Enforcement, Sanctions, and Accountability

A number of sanctions are available to the communes under their contracts in the form of penalties. The ultimate sanction the commune has is to terminate the contract, a powerful tool that allows it some flexibility. On the positive side, the contracts contain a number of incentives to encourage the private sector to improve performance, including a payment mechanism that gives the private operator incentive to connect new customers. Other than in the case of concessions, however, the private operator has little obligation or incentive to make significant investments in the infrastructure, and it is the obligation of the public sector to

invest in the assets.

As noted above, the administrative courts play an important role in enforcing the obligations of both parties and upholding the concept of “financial equilibrium,” which prevents one party from being unduly affected by a change in circumstances. The courts also enforce penalties imposed by the commune.

Because the arrangements are contractual, the public party “regulating” the contract is constrained from abusing its position by the need to reach agreement with the private party on any change in terms. Again, the administrative courts have played an active role in ensuring the public partner does not overstep its powers.

In the 1980s, concern arose that the awarding of contracts lacked transparency and the sector was tarnished with corruption. Legislation passed at the time that obliged communes to bid contracts competitively has since been strengthened through European Union directives on public procurement of goods, works, and services. Legislation was also introduced limiting the duration of contracts to prevent them from being extended for long periods to avoid a new competitive bidding process; however, a number of exceptions are allowed, which has meant these reforms have had limited impact.

An additional concern that the private operator did not have sufficient disclosure obligations under the contracts has been managed through legislation, and operators are now under statutory obligations to disclose data to the communes. The communes are also subject to some requirements to publish data.

Challenges

Over the years, calls for a separate agency to oversee economic regulation of the water sector in France have emerged from concerns that tariffs are not harmonized around the country and are on the high side, and that performance is sometimes compromised, particularly toward the end of the contract period when the private operator may seek to limit investment in maintenance and improvements. These calls have been consistently rebutted by the water industry, both on the public and private sides. Some believe the delegated contracts provide the necessary checks and balances, and that introducing a third party regulator into the arrangements would be inappropriate. One of the concession arrangements in place in Paris was not renewed with the private sector, and the relevant municipality brought service provision back into the public domain because of concerns about the service being provided by the private operator and a lack of transparency of information for determining tariff levels.

While legislative reforms have been introduced to ensure greater disclosure obligations and require greater transparency, concerns remain that accountability to the consumer is insufficient, and benchmarking among operators is too limited.

Table summarizes the advantages and disadvantages of the French model of economic regulation of the water sector.

Table Advantages and Disadvantages of the French Model

Advantages	Disadvantages
Clear separation of policy function (at national level) and asset ownership and oversight function (commune)	
Local entity (commune) overseeing performance	Limited capacity of some communes
Aggregation of services of communes (economies of scale) encouraged through legislation, with some aggregating along river basins	Aggregation not obligatory, probably leaving scope for further aggregation

	No central body setting tariffs, leading to lack of consistency and tariffs on high side
Standardization of contracts	Inconsistency in enforcement of contracts
Flexible contracts that can be amended, with courts determining on changes of circumstance	Still some lack of transparency in contract award and extension of contracts; three dominant private operators in market may reduce room for effective competition
Contracts with sanctions and incentives, with communes having ultimate sanction of termination	
Equilibrium between parties and performance of both parties of their contractual obligations ensured by administrative courts	
Obligations under law for disclosure of information	Limited disclosure of information; little benchmarking of private operators
	Limited regulatory oversight of public operators
	Limited number of contracts (concessions) in which private sector is investing heavily

The French system has useful elements, particularly with respect to aggregation of a fragmented system and the presence of catchment agencies at a relatively local level, that may be relevant to the Philippines. It should be recognized, however, that overall the capacity of the communes to manage and monitor contracts is considerably higher than that of the majority of LGUs in the Philippines, and the role of the local administrative courts in France to oversee compliance could be difficult to replicate there. The Philippines would need to ensure the availability of significant support at a local level.

Germany

The German system provides another example of water sector regulation by contract at the municipal level, but some regulation is carried out at the state level by state water authorities, which set water and sanitation tariffs.

Regulatory Framework

Germany is a federal system, with sixteen states. The main national law relating to water supply and wastewater disposal is the Federal Water Act of 1957, as amended in 1996. Each state provides detailed requirements for implementation of the act, and the municipalities are responsible within this structure for the provision of water supply and wastewater services and for the local environment. Generally, water and wastewater provision are managed separately. The water sector is fragmented, with over 15,000 different organizations providing water and/or wastewater services. Economic regulation is vested in the municipalities, which impose and enforce service standards conforming to federal and state requirements. The municipalities also control tariffs, either directly for companies operating under public law or through management or concession contracts for independent companies .Most of the water sector is publicly managed (*Regiebetriebe*) through municipal water departments and financed from the general municipal budget. Only 30 percent of the population is served by privately managed systems, which are mainly in larger cities. National regulations for water quality are implemented by the Federal Ministry of Health, which sets drinking water standards. No central regulatory authority is responsible for economic regulation of the water sector.

State Oversight

Each state has its own water authority that sets water and sanitation tariffs. District-based water authorities have delegated powers of legal control, and town-based water authorities are responsible for technical

services, granting licenses to small users, and providing advice. Local authorities are primarily responsible for provision and regulation of water and wastewater services. A concern is that the publicly managed systems are subject to political interference, particularly from strong unions with vested interests, which has resulted in low tariffs that do not cover the cost of operations and overstaffing. Two models of private sector participation are typically used in Germany:

- *Betreibermodell* is an operation and maintenance contract, whereby the private operator manages and maintains the system. Sometimes the operator also has investment obligations, typically where the operator contracts to construct a new asset and operate it for an unlimited or limited period of time. The contract contains formulas for price adjustments based on construction costs, input costs, and inflation.
- *Kooperationsmodell* is where a joint venture company formed between a municipality and a private operator takes ownership over infrastructure assets. The private operator is responsible for operation and management of the assets, while the joint venture as a whole is responsible for financing new investments. Under this model the joint venture combines regulatory and operation functions; Berliner Wasser is a good example. This model is similar to the mixed ownership company, or *impresa mixta*, also used in Spain and, to some extent, in France. It can be effective where the public partner has the capacity to manage the arrangement, but potential exists for differences between the public and private sector partners which have to be actively managed.

Corporatization

The growth of private sector participation in the German water sector has been limited by significant public opposition to it. Local governments are instead turning to corporatization of public utilities to ring fence assets and resources for the utility, achieve efficiencies, introduce performance incentives for management, and even raise financing. In 1986, 63.3 percent (by water volume) of the water systems were under direct public management (*Eigenbetriebe*), which diminished to 4 percent in 2005, while management by corporatized public utilities increased from 12.7 percent to 30.2 percent (Menard and Peeroo 2011)over the same period.
Corporatization also allows municipalities to distance themselves from service provision and create a buffer between operations and policy and tariff setting. Most regulation in the German water sector is carried out at the municipal level through regulation by contract (in the case of private sector provision) or through the accountability mechanism of a corporatized entity reporting to the municipal shareholder.

Table Advantages and Disadvantages of the German Model

Advantages	**Disadvantages**
National standard setting, implemented at local level	Politicized local tariff setting - resistance to charging an economic tariff persists so system relies on subsidies from budget.
Local oversight of performance	For publicly managed utilities, limited independent oversight
	Utilities not often ring-fenced from other municipal activities – can lead to underinvestment

Uganda

Uganda has adopted a form of public–public contract to introduce performance targets and monitor performance that has proved very successful in improving service standards in the larger cities. The tariff-setting function is negotiated between the public operator and the Ministry of Finance, and parliamentary approval is required for tariffs as well as the budget of the operator.

Regulatory Framework

Uganda has one publicly owned enterprise: the National Water and Sewerage Corporation(NWSC), which is responsible for provision of water and sanitation in large urban areas. It was set up as a government-owned parastatal entity under Decree No. 34 of 1972, and its legislative framework was strengthened by NWSC Statute No. 7 of 1995. The mandate of NWSC (section 5 [1]) is to operate and provide water and sewerage services in the areas entrusted to it on a sound commercial and viable basis. The principal functions of NWSC are to do the following:

- Manage water resources in ways most beneficial to people of Uganda
- Provide water and sewerage services
- Develop water systems and sewerage in urban centers and big national institutions throughout the country

NWSC is owned by the central government. It comprises around 1,500 staff members operating twenty water supply and sanitation networks (each a branch office). It is headed by a board of directors, who are high-level civil servants from different administrations and/or experts. The head office is in charge of asset development and management, strategic planning, and support services. The branch offices, each of which operates a water supply and sanitation network, are in charge of operations and maintenance, as well as relationships with the customers.

Two main ministries are involved in the sector: the Ministry of Water (MoW)and the Ministry of Finance. MoW is in charge of water policy, development, strategic planning, and regulation of the sector, while the Ministry of Finance is in charge of NWSC financing and manages the funds delivered by funding agencies. Parliament has to approve the budget of NWSC and the tariffs charged for water services. MoW appoints the NWSC board of directors.

Instead of turning to the private sector to improve services, the government chose in 2000 to set up three-year performance contracts (PCs), which set targets linked to performance indicators, between MoW and NWSC. Achievement of these targets is linked to performance incentives for the board of directors and management at the central office. The terms of each contract are renegotiated every three years by the parties, who focus on the choice of performance indicators and the targets. NWSC has, in turn, outsourced some of its non-core activities to the private sector.

Some smaller towns have brought in the private sector to manage the systems.

Incentives and Accountability

NWSC has internal performance contracts (IPCs) with its branch offices to translate the objectives of the PCs into operational goals and to foster improved performance by giving greater autonomy to the managers of the branch offices. These contracts are signed by the head office and teams of managers of the branches. The IPCs set targets and provide incentive performance payments to staff at the branch level. The incentive mechanism guarantees a minimum financial bonus once a minimum level of performance is achieved by the branch. Any further improvement beyond the minimum can result in additional bonuses, up to 50 percent of basic salaries.

The NWSC steering committee has a subcommittee that monitors NWSC performance under its performance contract with MoW. Senior management of NWSC also has a reward structure to provide incentives, with up to 25 percent of annual basic salary being payable only on achievement of specified performance parameters.

Parliamentary Oversight: Tariff Setting

The tariffs specified in the performance contracts need to be approved by Parliament.

Table Advantages and Disadvantages of the Ugandan Model

Advantages	Disadvantages

Centralised monitoring and oversight but performance contracts allow for accountability at local level	Successes and model might be difficult to replicate as NWSC has a strong reform mandate from government
Standardized national tariff-setting methodology, strong leadership	Not clear to what extent local branches can give input into policy
Monitoring and oversight centralised and consistent	Limited local autonomy

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