Privatisation of wastewater services

Summary of the Operation Performance Evaluation Review (OPER)

July 2003

The project

This project involved a partial privatisation under a Public Private Partnership ("PPP") scheme. It was one of the outcomes of the country's municipal initiatives during the early 1990s to improve efficiency and service quality of municipal utility entities. At the centre of this project is the municipality-owned sewerage services company that was transformed into a sole proprietorship joint stock corporation towards end of 1993. Before 1991, all water utility companies in the country were state enterprises, but in the wake of the post-communist era reform plans were adopted that sought to reduce the role of the state government. From the Bank's perspective, the project emerged as the result of a two-phase development:

- In September 1997, a consortium composed of three companies (together referred to as "the Sponsors"), won a 2-round competitive international tender for the partial privatisation of the country's waste water system. This process was modelled on an earlier, equally part-privatisation scheme, and that became effective about 6 months prior to this project. In late 1998 the Sponsors purchased from the municipality a 25 per cent stake, plus one share, in the wholly municipality-owned waste water company under the umbrella of a newly established Special Purpose Company ("SPC") to own this 25+ per cent shareholding. Concurrently, the Sponsors also concluded agreements with the municipality to take over management of the municipality's sewerage services company's day to day operations. The SPC was created as a vehicle to raise loan financing and attract other investors into the project, enabling the Sponsors to leverage the cost of their USD 86 million share purchase and sell down some exposure, while maintaining management control of sewerage company and majority ownership of SPC.
- Upon the outcome of the tendering process and standing by its earlier expression of interest to participate in the longer-term financing of the PPP, the Bank's Board approved in late 1998 an investment of under €24 million for the acquisition of SPC shares representing a maximum of 30 percent of the Company's capital and voting rights from the Sponsors. In December of the same year the Bank concluded related agreements with the Sponsors, although the actual share subscription took place only in December 1999 ('secondary purchase').

Project rationale

The wastewater infrastructure facilities, at the time its privatisation was conceived, were generally in a state of environmental degradation, poor quality and under-supply of essential infrastructure and services, inadequate financial performance, significant inefficiency in service provision, and deteriorating asset bases due to under-investment in maintenance and replacement. There was a tendency to ignore environmental externalities, with attendant consequences for health and pollution. It was a well-known fact, for instance, that the country's wastewater facilities, in terms of secondary treatment, covered an unsatisfactory low portion only, and that bringing the municipality's wastewater facilities in line with EU environmental standards was an important, if not an overriding concern at the time. But, meeting EU standards apparently was not linked to the sewerage company being privatised or not. Standard compliance would anyway be on the accession agenda.

Achievement of objectives

The stated objectives were the following:

- "The dividend paid by the sewerage company to SPC will be the main indicator of project success. This is because the dividend is exclusively a function of the Sponsors' ability, as co-operators of the sewerage company, to generate efficiency gains and additional revenue compared to the base year level of 1997"; and

- “Another objective of the Bank is to further and optimise private sector participation (PSP) in the funding and implementation of investments in the sewerage sector in the country and its capital city. A move beyond this first stage — PSP in operations —would be an indicator of success.”

Overall, the achievement of objectives under this Project is rated ***Good***, at best. It deserves mentioning, that, in the evaluator’s opinion, the envisaged efficiency gains, financial returns, and transition benefits are not attributable to the Bank’s involvement, since the Bank’s involvement was mainly a financial transaction that happened about one year after the strategic Sponsors had concluded this PPP undertaking. Moreover, the range and scope of services has not been markedly increased, at least from a consumer’s perspective, since the waste water coverage area remained basically the same “with” and “without” the project. From a service provider’s perspective, however, improvements occurred and are reflected by way of efficiency gains that translate into dividend payments to SPC shareholders.

OVERALL ASSESSMENT

The Bank’s operation, overall, is rated ***Partly Successful***. Conceding some benefit of doubt, the Bank’s additionality can only be ***Verified in Part***. This is chiefly because of the absence of ‘design and functioning’ contribution by the Bank – in a sense, the Bank ‘jumped on a running train’ – and a comparable “reasonable” funding potential from commercial sources was in place at the time when the Bank concluded its commitment, as the half-year earlier part-privatisation of the company provides evidence for. The ‘political comfort’ is a somewhat valid, but not unchallenged argument in support of the claimed additionality at appraisal. Environmental Performance rating under the project, both from a Bank’s as well as from the wastewater services provider’s perspective is rated ***Satisfactory***. Environmental changes attributable to the investment are ***None***. The project is in compliance with strategies and policies of the Bank.

The PPP was relevant and the more immediate objectives of generating operational efficiency gains and additional revenue sources were attained. Achievement of objectives is rated ***Good***. The Project’s financial performance is rated ***Good*** and the sewerage company’s performance is rated ***Excellent*** in view of dividend payments and current ratios over recent years. Also bank handling deserves a rating of ***Good***.

Transition impact and the Bank’s additionality

The Transition Impact is rated ***Marginal*** and pertains to the dimensions *know-how transfer* and *new business standards* at company level, and *frameworks for markets* and *new business standards* on sector level. The evaluator rates verified and future Transition Impact (TI) on the sewerage company’s level as ***Satisfactory***. For longer-term impacts to mature the risk is rated as ***Low.*** At sector level, the evaluator rates verified and future Transition Impact (TI) as ***Marginal***. For longer-term impacts to mature the risk is rated as ***Low***.

The Environmental Performance of the project is rated as ***Satisfactory.*** The Extent of Environmental Change is rated as ***None.*** The evaluator is unable to confirm these appraisal expectations in full and concludes that additionality is, at best, ***Verified in Part***.

BANK HANDLING

With the caveats pertaining to transition impact, additionality and environmental issues, the Bank’s handling is rated as ***Good***. One would have clearly wished that a more ambitious transition impact oriented approach had been adopted along with an earlier involvement by the Bank in the sector. Throughout the preparatory and implementation processes the Bank established and maintained (and continues to do so) a good relationship with the country’s Municipality authorities as well as with its co-sponsors in SPC.

The financial structuring of the project is complicated. The dividend calculation, in turn linked to that of the sewerage fee, is based on a model that absorbs in the range of 40 Window-Excel spreadsheet pages, as was learned. The legal documentation, regulating the various relationships among the Bank, the Sponsors and the Municipality, is rather voluminous as well. Attendant implications for preparation, implementation, monitoring and evaluation of this project are obvious. The operation team deserves credit for this effort.

MAIN OPER ISSUES AND LESSONS LEARNED

Appraising project mandate compliance needs more scrutiny and effectiveness. Concerns regarding a proposed project's compliance with Bank mandate dimensions need early flagging during the project preparatory process and dealt with more rigorously. Project proposals that do not hold adequate potential for mandate compliance, in spite of mitigating efforts, should be abandoned at the earliest possible preparatory stage.

Secondary purchase financing tends to limit scope for 'design and functioning' additionality. Where the Bank as a principal project financier seeks involvement in a municipal utility privatisation scheme, but is not actively involved in its design (as would be desirable), the Bank should employ a two-lane parallel approach. Whilst entering in an enhanced policy dialogue with the municipality to stimulate certain design features (here: linking municipal wastewater company share sale proceeds with a capex programme for the wastewater system), it also should condition these elements as part of its principal expression of interest to tender participants regarding its readiness for financing.

Need for closer coordination and collaboration with other donor or MDB parties. In cases where other multilateral development banks, the EU or other donor facilities are already or will be involved in a project that the Bank is considering to support, the Bank should more closely coordinate with these other sources, both to harmonize expectations and to optimize project outcomes.

MEI projects may require two separate evaluations at different stages. Due to the nature of concession-type projects associated with longer maturities, independent evaluations are suggested at two stages. In order to generate and feed back lessons from the preparatory and early implementation stages a lead-time of about two years after Bank equity investment is considered appropriate for a project evaluation. However, for gaining more insights and to caption the dynamics of maturing concessions it is recommended to bundle several such concession projects reflecting diverse maturity stages and to evaluate them under a special study evaluation framework.