



## Bulletin

- Water
- Energy
- Retailing
- Transport
- Financial services
- Healthcare
- Telecoms
- Media
- Post
- Competition policy
- Policy analysis and design
- Regulation
- Strategy
- Contract design and evaluation
- Dispute support services
- Market design and auctions

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## Water under the bridge

### REGULATING CHANGE IN LONG-TERM CONCESSIONS

*Frontier has been involved internationally in the design and review of a number of infrastructure concessions, which enable private companies to provide services while governments retain control of the assets. Drawing on this experience, we look at how concessions might be designed to be flexible enough to adjust to changing circumstances while protecting investors and customers.*

Delivering high-quality and environmentally sound infrastructure services to all is a fundamental objective of governments. To help achieve this, they often turn to the financial and technical resources and the business skills offered by the private sector – while remaining concerned to protect customers from monopoly power. Long-term concessions offer a way of combining public control of outcomes with private management of operations, and one that has increasingly become the standard model worldwide.



The concession contract can be used to specify the nature and quality of services to be provided, and the prices to be paid for such services by customers, in principle protecting both sides. One of the advantages of a concession, therefore, is that the contract itself acts as a regulatory tool. It should not, therefore, be necessary to establish the same scale of expensive regulatory arrangements as are needed when assets themselves are transferred to the private sector.

Many of these concessions have not, however, worked well in practice. There have been a number of high-profile failures in all sectors. United Water ended its contract in Atlanta, claiming that the condition of the network was worse than allowed for in the contract. Maynilad withdrew from its concession in Manila on the grounds that the regulator had failed to respond adequately to a massive increase (due to the peso's devaluation) in debts assumed at privatisation. And National Express withdrew from its tram and train franchises in Melbourne following financial difficulties.

#### DESIGNING FOR THE UNKNOWNABLE

However well thought through the original agreement, conditions are bound to change, radically and unpredictably, over the lifetime of the contract. Developments in the objectives of the concession, such as increased coverage targets, uncertainties over investment and operating costs (especially where knowledge of the state of existing assets is rudimentary), and a changing external environment all play their part in creating uncertainty. It is therefore essential to build flexibility into the design, in order to preserve the equilibrium between the interests of customers and investors represented in the original contract, and Frontier has experience in doing this for many different types of contract.

Indexation provisions – which adjust the pricing formula for inflation – are just the starting-point. Changes in other economic variables beyond the control of the concessionaire, such as exchange rates and construction prices, can also be built into the contract. So, at least in theory, can other factors that can be expected to change, or which it is intended to change, such as objectives for the extension of supply.

But the best-written contract is dependent on the availability of information, which is often inadequate. Moreover, it is impossible to foresee all eventualities. A “complete” contract, which does not need to be reviewed in 20 years, is hard to design or even contemplate. Even the extremely comprehensive contracts, running to many hundreds of pages, which govern the public-private partnership for the London Underground, contain provisions for periodic and extraordinary reviews of prices and deliverables.

It is therefore sensible to provide for future revisions, which will be needed in order to maintain the contract's original intention. For example, if additional investment would be needed to meet new standards of service and environmental quality, the concessionaire could reasonably expect higher payments, if the spirit of the original bargain were to be met. Similarly, the concessionaire should be entitled to recover the additional costs of providing or extending arrangements for providing services on affordable terms to vulnerable customers, if the government or municipality changed its requirements. As such revisions cannot be automatic, some process for deciding on revisions needs to be built into the contract design, together with a means of resolving disputes between government and concessionaire – such as a regulatory office.

The opportunity to make changes to the terms of the concession may be grouped together to create, for example, a five-year price review cycle, as has become a familiar feature of regulatory life in the UK and elsewhere. Such pre-determined periods avoid the uncertainty that would be caused by frequent changes, and also help to concentrate the analysis and negotiation work required of both regulator and regulated into limited periods of time. Of course this approach does not remove all uncertainty from the contract, which still retains some open-ended elements since the cost of new obligations would not be determined until the next five-year review. But it is an approach that could be used under any of the systems discussed on the facing page.

### WHO'S IN CHARGE?

Specialised economic regulators are a common feature of many privatised utilities internationally. However, they may not always be appropriate – or necessary – in the types of arrangements we are considering here. As we have seen, the regulatory task is more limited than in the regulation of wholly privatised utilities. Moreover, in many cases, infrastructure services are a municipal responsibility. Only the very largest municipalities are likely to be able to bear the costs of setting up a separate regulatory office.

In some circumstances, it may instead be possible that a joint management unit, with an independent chairman and representatives of both the government or municipality and the concessionaire, can deal with disputes under the contract and negotiate adjustments to allow for changing circumstances. But this is unlikely to work well where both sides hold entrenched views or when large changes need to be made. In such situations, although a joint management unit may be useful as a first port of call, some provision for appeal to an outside body will be necessary as well.

One option is obviously to allow appeal straight to the courts. These, however, are often not well suited to the resolution of complex disputes arising under concession contracts – either because of the time and cost involved, or more importantly because of their lack of specialist experience and expertise. If an alternative option exists in the form of an authority with the responsibility to hear appeals on decisions taken by regulators – such as the Competition Commission in the UK – it may provide a quicker, cheaper and more effective solution to the problem. Similarly, it would be possible to use a super-regulator – such as has been established in Bolivia – to hear appeals.

Where such options are not available, however, compulsory arbitration may be the best resolution procedure to build into the contract. Normally, the arbiter would not have the wide authority of a regulator, but be given a specific remit to resolve disputes in a way that maintained the economic and financial equilibrium of the original concession. This task would involve interpreting the contract in changing conditions, such as a major change in desired outcomes for service and environmental quality, or a major change in operating conditions. The arbiter should be charged with monitoring the way in which the concessionaire is delivering the desired outcomes established for the concession, and reporting the results to customers and to the public.

The possible role of such an arbiter is illustrated in Figure 1.

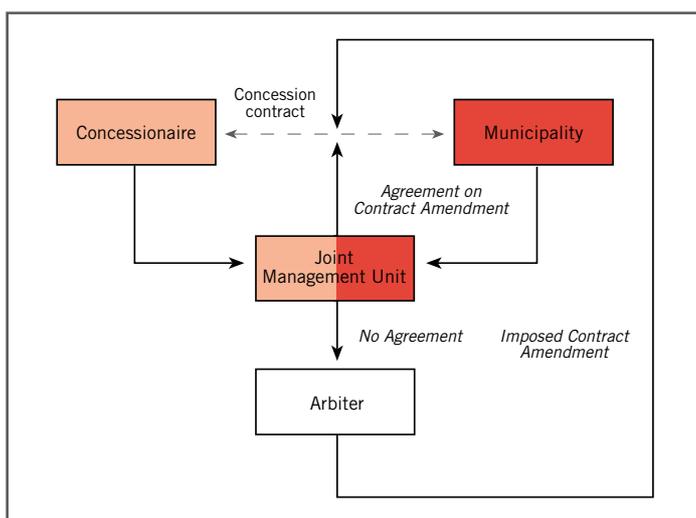


Figure: The role of the arbiter

The public-private partnership on the London Underground explicitly provides for such an arbiter to rule on the periodic and extraordinary reviews provided for in the contracts. This is a departure from earlier plans, and marks recognition of the “incomplete” nature of the final contracts.

The key to success under such an approach is to focus on getting the economics right—thereby helping to create a shared understanding of the objectives of the concession, and of the desired outcomes. The contract should focus on articulating the purposes of the concession rather than attempting to cover all eventualities in advance—a legal endeavour that is doomed to failure.

In order to achieve this firm foundation, there needs to be an understanding of what would constitute reasonable returns to the concessionaire, what would constitute a reasonable delivery of service to customers, and what is a reasonable level of environmental quality. There should be clarity about how the arbiter would take account of improvements in efficiency when making adjustments to the contract. The aim should be to create an environment in which the discussion is focused on how to maintain equilibrium through adjustments to prices and quality, rather than allowed to degenerate into sterile debates over the exact interpretation of contract wording.

Frontier Economics' staff have worked on the design of concessions for municipal infrastructure in Bulgaria, where we introduced a framework for municipal gas distribution companies, South Africa, where we wrote the licence conditions for a contracted energy distributor and Indonesia, where we advised on the redesign of the Jakarta water concessions. Drawing on this experience and knowledge allows us to recognise how to design and implement a conservation contract and an overall regulatory environment that meets the requirements of all parties at the lowest cost.

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