IMPLEMENTING SOCIAL POLICY INTO CONTRACTS FOR THE PROVISION OF UTILITY SERVICES

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Abstract: To be successful, social policy must form an integral part of the political, legal and regulatory fabric of a country. When part of the delivery of utility services is performed by a private sector entity, social policy requirements need to be embedded in any contractual mechanisms used to define the relationship between the public and private sector. These contractual mechanisms are used by the private sector to protect it from the public sector's power to unilaterally change the nature of their relationship through legal and regulatory functions and by the public sector to establish the role of the private sector and create incentives to keep the private sector focused on the desired outcomes. This note provides guidance on how each aspect of a contractual mechanism must contemplate social policy implications and adapt to social policy changes over time. It also suggests that in order for contracts to properly implement social policy, social policy experts need to play a fundamental part in contract negotiations; they need to be perceived by contract teams as forming part of the solution, rather than part of the problem.

Keywords: *contract, tariff, connection, dispute resolution, incentive*

The purpose of this note is to encourage the design of contractual mechanisms that implement pro-poor social policy into the management of water and energy utilities. The search for effective social policy implementation and the ability to enforce its precepts make targeted contractual mechanisms an essential part of pro-poor utility reform.

These contractual mechanisms are used by the private sector to protect it from the public sector's power to unilaterally change the nature of the public-private relationship through legal and regulatory functions. They are also used by the public sector to establish the role of the private sector and create incentives to keep the private sector focused on the desired outcomes. Social policy must be imbedded in such contractual mechanisms to ensure that the private sector is aware of what is expected of it and that the incentive structure of the contract encourages the timely fulfillment of those expectations.

Three examples are used in this note to show how contractual mechanisms can be used to implement social policy: setting tariffs, achieving connection rates and dispute resolution. Policy related to these three areas include providing increased access to services for the poor, encouraging the use of services amongst the poor, conservation of resources, ownership, monitoring and accountability.

The implementation of social policy assumes a certain level of flexibility and the ability to address inevitable change, in particular in the more comprehensive forms of private sector involvement in utility services, which tend to last for many years. This change may alter the social policy itself or the manner in which the social policy is implemented. The contractual mechanism must be able to address all changes, while protecting the integrity of the agreement between the public and private sectors and the interests of the different parties.

Contracts for utility services are generally subject to strict confidentiality, which creates particular challenges to the extent that transparency is needed to implement aspects of social policy (this particular challenge is discussed in more detail in Section 3 and throughout this paper). This confidentiality also makes it difficult to provide examples of how social policy has or has not been implemented in actual utility projects. For this reason this note will make reference to a fictional case study using an amalgamation of facts from different projects that this author knows well, but would not be in a position to discuss if there were any risk of identifying the project or parties to whom those facts relate. This fictional amalgam will be a water and sanitation concession located in the country of Nowatta.

After introducing the subject (1), this note assesses the nature of social policy (2) and contracts (3) in order to discuss how contracts can be used to implement social policy (4). It then describes the changing nature of social policy and how contracts must be able to address change (5). Finally, this note discusses a few of the practical challenges facing those endeavoring to implement social policy into contracts (6).

1. Introduction

To be successful, social policy must form an integral part of the political, legal and regulatory fabric of a country. It must inhabit the normative function of Government, driven and defined by political philosophy, social mores and public demand. Governments will implement these requirements more or less quickly, using the legislative and regulatory mechanisms available to them. This normative function is protected by democratic, procedural and political mechanisms which themselves impose incentives on politicians and government officials to ensure the implementation of social policy.

The implementation of social policy takes on particular importance in the delivery of water and electricity services ("utility services"), and is often rendered more difficult when those utility services are delivered by companies that are to some extent insulated from the relevant democratic, procedural and political mechanisms. These companies may not be subject to the traditional drivers of social policy, and therefore targeted incentive mechanisms may be needed to ensure that they implement the relevant social policy.

When delivery of utility services is performed by a private sector entity, social policy requirements may need to be embedded in any contractual mechanisms used to define the relationship between the public and private sector. These contractual mechanisms are used by the private sector to protect it from the public sector's power to unilaterally change the nature of the public-private relationship through legal and regulatory functions. Though these contractual mechanisms will not normally limit the public sector's right to pass laws and issue regulations, they provide the private sector with compensation or other benefits where the public sector chooses to use its discretionary powers in certain ways. The public sector will also use contractual mechanisms to bind the private sector to the project and create incentives to ensure that desired outcomes are achieved. Therefore social policy should be imbedded in such contractual mechanisms to ensure that the private sector is aware of what is expected of it and

that the incentive structure of the contract encourages the timely fulfillment of those expectations.

Clearly, Governments have been entering into contracts for centuries. In theory, social policy should be implemented into those contracts as a matter of course. However, most Government contracts focus on performing specific works or delivering goods, over a relatively short term. The need to embed social policy in such contracts is limited. The delivery of utility services by the private sector involves long-term contracts with duties and obligations closely associated with the delivery of public and social services, and therefore the need for the private sector to deliver services in the context of heavily regulated and politically charged sectors. This is a relatively new approach to utility management and therefore requires an adjustment to contractual practices of the past.

In most developed countries, the private party providing utility services is subject to general changes in law or regulation, and therefore to the implementation of social policy at law. However, the desire to attract foreign investment into developing countries through utility projects has enabled investors to seek protection against changes in law and regulation and political interference. These same protections can frustrate or limit any effort to change social policy or the way it is implemented.

The study of social policy in contractual mechanisms raises a number of questions and opportunities for analysis. These can be reduced to two key questions, 1) whether and how social policy should be implemented by contract, and 2) how contracts influence social policy.

Addressing the second question first, in essence, a contract is a formalized set of rules which form the basis of a relationship between two or more parties. A contract says what it says, subject to the legal climate in accordance with which that contract is interpreted and implemented. A contract does not set social policy *per se*, it only reflects the efforts of its drafters. If the drafters do a bad job or do not foresee the contract's implications or the changes that will impact that contract, then it is still a matter of drafting, rather than the contract itself setting policy. Though efforts to understand how different contracts have in the past had an influence on poverty reduction are interesting and useful, they relate only to the contract in question. The impact of any contract will depend on the way that contract is drafted, the nature of the parties involved, and the legal climate in which that contract is embedded. It is not possible to say that a specific "type" of contract will always have a given impact, for example,

on poverty reduction. But, it is important to use what has gone before as an example of drafting mechanisms that may or may not work well when implementing social policy. For these reasons, this note will not address in any detail this second question.

Turning therefore to the question of whether and how social policy can be implemented by contract, three associated questions arise:

What is social policy? A contract is reflective of its drafter's intentions and skills, it is not in itself creative. Therefore the desired social policy must be understood in detail before it can be faithfully implemented by a contract. (Section 2)

What is a contract? Utility projects can be financed, implemented, managed, operated and regulated by some combination of public and private sector entities.[1] These relationships are generally based on some form of agreement, which itself will be couched in a variety of legal influences that will alter the way that agreement is interpreted, applied and enforced. In order to address the different variations of infrastructure projects wherein social policy will need to be implemented, this paper will use the term "contract" to mean specifically the written document that creates the relationship between the public and private sector, but will also include analysis of the laws, licenses and regulations that underpin any legal agreement. These basic elements of a contract are interrelated and interdependent. (Section 3)

How can a contract be used to reinforce the desired social policy objectives? Once we understand the nature of a contract, we must understand how its elements interact with social policy objectives and how the contract can be used to implement those social policy objectives. A contract imposes a risk allocation matrix that creates responsibilities and rights for the parties.[2] It is through this risk allocation that social policy can be implemented. This note identifies and discusses three of the key contractual provisions wherein social policy mandates can be adopted. (Section 4)

One of the limitations of a contract is that it is fixed in time. A contract can provide formulae to implement change when certain trigger events occur. These formulae are still, relatively speaking, fixed in time. A contract can also provide for procedures to assist the parties when a change is desired, though any conditions or requirements for such a policy will be fixed in time. Generally speaking, a change in the contract to follow a change in social policy requires

[1] Delmon, Water Projects: A commercial and contractual guide (Kluwer 2001).
[2] Delmon, Project Financing, BOT Projects and Risk (Kluwer 2005).

the agreement of all the parties to the contract, and those parties must also agree on the detail of the change in social policy. (Section 5)

2. What is social policy?

Social policy promotes social development; it creates processes intended to increase

- the ability of individuals to improve their wellbeing,

- the capacity of social groups to exercise agency, improve their relationships with other groups, and participate in development processes, and

- the ability of society to reconcile the interests of its constituent elements, govern itself peacefully, and manage change.[3]

In utility services, social policies seek the promotion of equity and quality of services, responding to debates around the public good aspects of infrastructure and energy, increased access in rural areas and for the urban poor, while being a natural complement to economic development with both intrinsic and instrumental value. The fundamental nature of sustainable social policy requires finding a balance between equity and social justice on one hand and economic growth and financial viability on the other.[4]

Contracts for utility services are not common mechanisms for implementing social policy, but they can be effective instruments. Or, if social policy implications are not contemplated during contract design, contracts for utility services can be effective impediments to implementing social policy. The contract may set out the social policy itself, but more importantly should implement drivers that are designed to achieve social policy priorities.

Whether public or private, those required to implement social policy need clear directions on what that social policy entails and how it is to be implemented. This requires the identification of drivers and incentives structures designed to achieve particular elements of social policy. Similarly the nature of the incentives used to ensure implementation will change with the nature of the implementing party and over time. Waiting for the contract drafting phase

[3] Anis Dani, New Frontiers of Social Policy (World Bank 2005).

[4] Ibid.

to decide such issues may provide the impetus for difficult decisions to be made generally results in poorly thought through processes and incomplete implementation of the relevant policy.

In the Nowatta case study, social policy gave a particular priority to the delivery of services to the illegal slum areas on the southern border of the capital city. Given the hurry to agree a contract for service provision, the contract drafters did not have time to explore this issue further and a provision was included in the contract indicating vaguely that the operator would implement mechanisms to provide services to these areas in compliance with local law and policy. Local law did not recognize these illegal communities, and the contractual provision was so vague that the operational management ignored it completely.

3. What is a contract?

Contracts are the foundation of the relationship between the public and private sectors; they are the written record of the agreement between the parties. But a contract is only part of the risk allocation scheme. It fits within the overarching context of applicable law and the influence of secondary legislation (such as regulation, licenses and permits). This context can limit the scope of the contract, decide the interpretation of the contract and imply terms into it in order to ensure that the contract conforms with societal concepts of proper dealings. The contract itself is not a creative driver, it is a formalization of the chosen policy objectives. It is also worth noting the different natures of the three key elements of contractual obligations: contract, law and secondary legislation/regulation.

Parties

The nature of the party entering into the contract is important to the nature of the contract. Generally speaking any person (whether legal or natural) can enter into a contract, though applicable law will apply certain limitations. For example, some public bodies do not have the power (or *vires*) to enter into contracts (or at least not without approval from some other public body). But, ion practice every party is different, and its very presence alters the nature of the contract. A party may be less experienced with similar contracts, less credit worthy or less stable (for example political entities which can lose power and position following an election), and therefore more likely to breach the contract or need to change the terms of the contract. The

nature of the parties to the contract is therefore an important part of the risk allocation of the contract.

The private sector is accustomed to establishing clear rules and agreements by contract between itself and its commercial partners. The public sector is less familiar with the strict constraints of contracts and instead tends to create fluid, less formal relationships, using its influence to alter an agreement where necessary.[5] These divergent approaches to contracts make it more likely that public and private sector partners will fail to achieve a meeting of the minds on how the contract is to be implemented. It also means that public sector representatives without an understanding of the key role of the contract and its binding nature may not appreciate the importance of its terms and the contract negotiation process.

Relationship between the parties

Contracts provide parties the opportunity to define their own relationship. As a concept it is eminently flexible and able to address all issues and concerns that the parties might have; but is limited by a number of things, primarily by the applicable law and the skill of the drafters. Applicable law limits what can be agreed in a contract and implies terms into the contract. It may apply special requirements to contracts and even a different set of rules for contracts, e.g. those involving the public sector. A contract is also limited by what it says. If the drafters write something in a fashion that is unclear or forget to address certain issues, then the contract will be deficient.

There are other ways of creating or defining relationships, in particular corporate mechanisms. The partners can together form a company and the rules that govern that company, such as voting rights, liability and distribution preferences, will bind the parties/shareholders. For example, in public/private relationships, joint stock companies may be formed (allowing public and private shareholding) or the public sector is given a golden share in a private company to give it special rights. This paper will focus on contractual (rather than corporate) mechanisms and the legal context in which those mechanisms operate.

[5] It should be noted that some companies, in particular those steeped in a very public sector approach to business, will have more of a public sector attitude towards contracts.

Contract

Contractual agreements provide a common method of managing private sector involvement in public sector projects. They allocate risk between the private sector and the public sector and set out the whole of the commercial arrangement between these parties. Depending on the nature of the private sector involvement, the contract used could involve any number of conditions and obligations and may be called, for example, a management contract, an operating agreement, a concession agreement or an implementation agreement. This note will not use any of these labels to describe utility contracts given the patent inaccuracy of using such terms as a generic for what is otherwise a fantastically diverse and complex area.

A contract is easy to draft and to sign. There may be rules of formalization of a contract, but generally speaking contracts are eminently flexible. They are also easy to change, so long as all parties agree or a provision allowing such changes has been included in the contract. Contracts are not, however, transparent, in result or process – i.e. it may be difficult for those who are not part of the contract to obtain information on what decisions are being made under the contract. Contracts are personal to the parties and generally include confidentiality provisions restricting their dissemination. Contractual disputes before a court of law are generally transparent, but disputes resolved by arbitration or some other contractual dispute resolution mechanism can be made confidential and are therefore not transparent.

Law

Contracts are ultimately flexible, the parties alone establish their terms. However, the contract will be interpreted in the context of the applicable law, which may imply terms into the contract. Each legal system has its own peculiarities. The Anglo-Saxon legal tradition allows greater freedom of contract, while the French civil code tradition has developed a comprehensive body of law over the past 400 years that applies to public-private infrastructure projects. For this reason Anglo-Saxon contracts have a reputation for being long and detailed, setting out every aspect of the commercial relationship. Contracts in jurisdictions following the French tradition can afford to use shorter agreements which rely on established law to provide many of the details, so long as they have adopted in whole the sophistication of the French legal system, including its judicial system and jurisprudence.

Law is generally created through some parliamentary or governmental process and is therefore difficult to enact and to change. This may not be the case where the party in power has

a large or super-majority in parliament or control over the Government and can therefore dictate the legislative agenda. The result of legislative action is generally transparent to the public, though the process for reaching that result in often opaque with some key discussions and debates held behind closed doors. Disputes arising in relation to laws are often addressed in the open forum of a court of law and therefore transparent to the public.

Secondary legislation/regulation

Laws often allow Governmental bodies to provide further rules for their application. These rules are known as secondary legislation, and may include regulations, licenses or permits, while the law permitting secondary legislation is known as primary legislation. Secondary legislation is generally easy to enact and change subject to any constraints imposed by the primary legislation. The process for its creation is normally opaque (performed internally by the Government agency – unless some process of consultation or publication is required) while the secondary legislation itself is in most cases transparent once enacted.

Private investors will want to restrict the rights of the public sector to alter the commercial relationship through regulation and may therefore require that some recourse be available against the public sector for any unilateral change that affects the private sector's costs or ability to perform its obligations. This regulatory risk may be reduced where the host country has a history of a commercially reasonable approach to changes in regulations. The private sector may want a right to challenge any decision of the regulator that is inconsistent with applicable legal and contractual obligations. This right of recourse will help to ensure that the Government complies with, and does not act outside, its mandate. To this end the private sector will need to consider the actual availability, accessibility and efficiency of the recourse provided.

4. How can a contract be used to reinforce the desired social policy objectives?

Contracts influence behavior by creating incentives. Incentives are simply that which motivates an individual or organization to act, make a decision or expend resources in a certain manner. The creation of incentives is an art rather than a science, just as needs, wants and perceptions change, so too will effective incentives, even if they are originally well designed. Effective incentives must be designed into the project contracts to ensure that they are understood, immutable (or at least difficult to change) and transparent. An incentive works best

when all parties understand its implications. Incentives also need to be targeted (focusing on the desired outcome with limited distortion of other aspects of the relationship), flexible (to evolve with changes in policy), clear (easy to follow, implement and monitor) and sustainable (viable over the long-term of the project). If the incentive creates too much benefit or too much punishment then the ability of that party to continue effectively with the project may be impeded. There is much debate as to which is more effective, positive or negative reinforcement of behavior, the carrot or the stick. For ease of reference, this note will assume that positive reinforcement is more efficient.

Incentives need to be designed to the proclivities of the parties to be incentivized. Each party will have different drivers, and those drivers may change over time. The most obvious driver is money, where penalties are assessed for undesirable behavior or where bonuses are paid for desirable behavior. But money may not be the most efficient motivator. For public figures, negative and/or positive publicity may be more effective. Reputational impact may be important for commercial parties as well. Future opportunities and liabilities may encourage a party to bear a certain amount of pain in the short term.

This section discusses how social policies can be implemented into a contract using the example of contractual provisions related to tariffs, connection rates and dispute resolution and how those provisions implement the following social policy goals:

- Improving access to services for the unserved,
- Encouraging the use of the services amongst the poor,
- Conservation of resources,
- Community ownership of solutions,
- Monitoring of social policy achievements,
- Accountability for achievements of those in a position to influence achievements.

The purpose of this section is not to give an exhaustive list of the ways in which contractual mechanisms can be used to help achieve social policy goals, but rather to indicate some of the mechanisms that can be used and hopefully inspire the creativity needed to identify the opportunities in each situation and scenario, as each project will present a different set of scenarios, different needs and new opportunities.

4.1 Tariffs

A contract will provide a number of mechanisms for the private sector to obtain compensation for the delivery of services to consumers. For example, the utility may charge tariffs based on the amount of service delivered or for each different service, or a fixed standing charges for the opportunity to use the service and for some or all of the use of that service. The level of tariff that can be charged is generally regulated by the Government to avoid rent seeking and to ensure affordability of essential services.

The contractual mechanisms for setting and imposing tariffs will be implicated in a number of areas in the contractual agreements. The following is a rough summary of some of the key areas.

Setting tariffs

The nature and continuity of the project payment stream will be of central importance to the private sector, who will want to ensure at least for the medium term the stability of its income and the return on existing capital and new investment. The private sector may not be willing to bear the risk that over the life of the project the Government will allow it to set tariffs sufficiently high to satisfy its needs. Therefore the project contracts often include a formula for setting tariffs which will ensure a return on capital investment or some other security of revenue.

Collection of tariffs

Where the payment stream for the project comes from tariffs charged to consumers, the service provider may need to have the right to collect tariffs directly from consumers. This may not be possible under local law, which may place a restriction on private sector involvement in collection of tariffs from consumers for utilities. The service provider will also need to consider practical issues related to collection, such as any restriction on its ability to impose sanctions for

non-payment, the propensity of the local population to pay utility bills (particularly water bills), and the incidence of illegal connections along with the scope for applying sanctions to the culprits.

These same contractual mechanisms can be used to incentivize the parties to implement social policy:

Access to services for the unserved

The cost of service needs to be low enough to be affordable to the poor yet high enough to incentivize the private sector to bear the associated collection risk including the cost of connection, the cost of providing services to the poor and the cost of collection of bills from the poor.

The *tariff formula* serves two main purposes, to ensure that the private sector receives compensation of a reasonable amount if it delivers services in an efficient manner and to share the burden of providing that compensation "fairly" amongst the different types of consumer (through different tariff bands) and the taxpayer (through subsidies).

Cross-subsidies require some consumers to pay more for the service delivered than other consumers. Industrial and commercial consumers often pay a different rate than agricultural consumers or domestic consumers. Equally the rich often pay more than the poor and the large user more than the small user. The Government may also choose to reduce the burden of utility tariffs on consumers by providing subsidies; this involves the transfer of wealth from the general pool of tax payers to the specific pool of utility consumers.

The contract is the wrong place to create different blocks or strata for tariffs or subsidies. The decision to provide subsidies or cross-subsidies needs to reflect an agreement between those elements of the Government that manage finances and social policy. There must be sufficient flexibility in the tariff mechanism to allow those tariffs to reflect current best practice in social policy while also supporting the economic position of the country. It is therefore essential that the tariff formulation be flexible to allow the Government to allocate tariff burden as appropriate while protecting the private sector's agreed revenue stream if it provides services as required.

In Nowatta, the contract defined a tariff mechanism, including rising block tariffs, to be applied during the first year of the contract. It also provided mechanisms to adjust tariffs annually during the period of the contract. However, the contract very clearly acknowledged the

right of the regulator to set tariffs and adjust the cross-subsidy mechanism as it thought appropriate. A financial model was attached to the contract and which was to be implemented by the relevant regulations, which described the returns that the private investor was to receive over the period of the contract. Thus the regulator was able to adjust the tariff to implement social policy as he saw fit and the private investor's promised return was protected through the contract.

Collection risk will be higher for services delivered to poor neighborhoods, or at least they will be perceived to be higher. This stems not just from the relative poverty of the consumers and therefore likelihood of crisis to affect their ability to pay, but also from their lack of access to bank accounts or credit cards, their inability to access internet or other electronic media, their location often in areas at some distance from the utility's customer service centers, fears from collection agents unwilling to venture into certain neighborhoods, illiteracy, lack of fixed postal address, nomadic or transient nature or informal legal status (making them hard to sue for non-payment).

These issues can be addressed by creating communities of interest – the collection risk of an entire community of poor households will be lower than those associated with a single poor household. Also, the tariff formulation can include consideration of the increased cost of delivering services to the poor. This may represent more than the simple offset and deduction of the cost of service to the poor; it may also include an incentive bonus for each poor household connected and served or a penalty if target service delivery to poor households is not met. Whatever the solution found, the nature of collection needs to be flexible enough for the service provider to tailor service delivery and tariff collection to the context of the consumer.

The Nowatta contract created an incentive for the private sector operator to connect poor households by requiring that a fixed portion of all connections made be to poor households. This mechanism worked well in the short term. It focused the operator's attention on connections for poor households and through the service level requirements set out under the contract it required the operator to ensure that the network associated with those connections delivered services to an acceptable level. However, it suffered from two key challenges. The formulation to identify poor households was fixed in the contract, creating inflexibility in the event of social and demographic changes altering the identified characteristics of a poor household. Also, as a negative incentive, it motivated the operator to do as little as possible to satisfy this condition. To

the extent that these social connections were not profitable, the operator had to find additional revenues from other consumers to make up the difference, creating additional stress on the financial model for the project in the early years when significant reforms within the utility were carried out. The operator therefore tried to limit the number of social connections performed in the early years of the concession. Another approach would be to fund some of the cost of social connections from Government subsidies, creating an additional source of revenues for the utility.

In the case of both the negative and positive incentives, the operator is motivated to use its creative energy to expand on the definition of "poor households" to include as many of the other more commercially viable household connections that might not fit exactly within the contractual definition of "poor households". Also under both scenarios the operator will be motivated to pursue low hanging fruit, e.g. to connect first those households closest to existing mains, in areas where system capacity is good, and in areas of higher standards of living, where households are more likely to be able to pay their utility bills. The philosophical difference is, however, significant. Under a negative incentive the operator will seek to avoid the obligation, under a positive incentive the operator is encouraged to fulfill the obligation aggressively. The positive incentive, when funded by subsidies, also provides additional revenues to the utility while encouraging more focused and possibly entirely output based Government subsidies.

Encouraging the use of the services amongst the poor

The obvious mechanism available to encourage usage amongst poor communities is to make the service available and keep it cheap, but often this is not enough. Information flow is key. The communities must understand what costs will be and how to manage their usage. The free water provided in South Africa gives a clearly inexpensive resource to all households. But the poor are often not connected, so they do not receive the free water. In addition, poor households are often sensitive to the cost of water in excess of the amount provided for free. Yet, it may be difficult for poor households to assess what proportion of their free allocation they have used (where for example they are not metered). Poor households must also be able to trust the water they receive. They must understand what uses can be made of it, be warned when quality falls and know how to treat the water for special uses, such as artificial feeding for infants. This can be achieved by mandating information flows to poor communities, delivered in a manner tailored to the circumstances of the poor communities. If the private operator is to

provide this information, then penalties or compensation should be linked to its provision in the manner desired. This information obligation is often coordinated with Government or regulator information obligations to improve dissemination through multiple networks.

Conservation

Ironically, while we want to keep costs down for poor households to use services, we want to keep them high to help conserve resources. Electricity provided at a very low price results in waste of power and therefore fuel and draining of the capacity of the grid to serve other areas. Many Governments provide subsidized electricity to agricultural communities, or turn a blind eye to illegal connections to electricity grids. This practice results in the misuse of a valuable resource, and often reduces the community's appetite for new, more efficient technologies. These same communities are often allowed to mine ground water at no cost and with little if any regulation. Free electricity and ground water motivates farmers to use inefficient open trench irrigation techniques, wasting power, diverting valuable ground water and causing environmental damage to vulnerable water tables. Several Mexican States are experiencing just such crises. While conservation efforts should be encouraged, both through education and pricing mechanisms, where one person's connection provides services for a number of households (e.g. where neighbors share a common water tap or where the pump that draws water into the local water tower is powered from one household), high tariffs charged to large users may punish otherwise efficient and socially responsible practices.

Ownership

One of the most effective methods of consumer empowerment is to ensure that each consumer has the standing to be involved in consultation exercises around service delivery, major regulatory decisions, tariff setting, major capital works, refurbishment programs and policy changes. Though this standing is normally created at law or by regulation, contractual confidentiality provisions and dispute mechanisms need to be reviewed to ensure that they do not withhold information or restrict third parties from involvement in important decision making processes. Balance must be achieved between the private sector's desire for quick and efficient processes and to protect commercially sensitive information against the need to create ownership amongst consumers and transparency of information and processes. The consultation process to

decide whether and how to build a fifth terminal at Heathrow Airport in the UK lasted over a year and cost the Government and prospective investors an enormous amount of money. This kind of experience causes private sector investors to shy from extensive consultation processes.

Monitoring and accountability

Monitoring the proper implementation of tariff policy can be challenging where that policy is imbedded in a contract. Transparency can be achieved through the regulatory mechanism to provide needed information to consumers so that they can make their voice heard in the decision making process. The process of regulatory decision, including the information that is used as the basis of that decision, can be made transparent. This means that information provided under contract must also be free of confidentiality restrictions. The regulator should also be accountable to the private sector and to consumers for his decisions. Stakeholders should have standing to challenge those decisions. Therefore contractual dispute resolution arrangements (as discussed below) need to be considered carefully to avoid disenfranchising consumers from important decisions and important dispute resolution processes.

The Nowatta contract achieved laudable levels of transparency. All corporate information, including accounts and performance measures, were communicated to the regulator and made available by the operator for public access at their offices. This transparency had its limitations. In particular subcontracts and agreements between company shareholders remained confidential, though they influenced many important issues such as decisions related to technology used in billing, pumping and water treatment, management of a part of project revenues, and the selection of senior management.

4.2 Connection rates

Increasing the number of connections is important to enhance financial viability since utility services delivered by networks or systems usually benefit from economies of scale, reducing the marginal cost of operation. Contracts will often include performance targets based on connection rates or numbers of connections, to demonstrate the improved efficiency achieved by private sector participation. However, connections are also expensive to install and require the extension of the network to the neighborhood where the prospective consumer is located. Given the cost of making connections, the private sector may be less inclined to seek to connect poor

households given the proportionally higher costs and the more limited amount of revenues available from such connections. Both of these issues impact particularly heavily on poor households. This raises a fundamental question: what is a connection? In order to ensure equity prevails over the choice as to which connections to provide and when, the contractual mechanisms around making connections and connection oriented performance requirements will need to create incentives to encourage the service provider to connect households of different socio-economic strata and location, possibly using different connection technologies, focusing on connections in specific geographic areas or allocating resources to achieve a certain proportion of socially driven connections. Of course each of these methods relates only to the distribution of poor households on the day the mechanism is designed, it will need to change as the distribution and needs of poor households change.

Access to services for the unserved

Managing connection costs is key to providing access to poor households to utility services. The principle cost is the extension of mains and high voltage lines to poor communities. These trunk lines need to be provided before any meaningful connection policy can be implemented. Left to its own devices, a private sector operator will extend trunk lines to areas which are most likely to be profitable (net of the cost of extension of the trunk line and the cost of attracting the consumer). Often, poor neighborhoods do not hold the promise of profitability sufficient to motivate the operator to undertake the cost associated with extending the network.

Once connection by poor households to local mains services is possible, the nature of a connection must be considered. In some circumstances, the nature of access to services may differ from poor to rich households. If poor households are happy with yard taps or community stand-pipes these represent much better value for money for poor communities, the local community may provide in-kind assistance, such as manual labor, to reduce the cost of connection. In other contexts such alternate technology would be unacceptable and may require household connections but may accept smaller diameter pipes or lower voltage connections where these will reduce the cost of connection significantly. Many Governments and donors provide grant funding to subsidize or completely defer the cost of connection to poor

households.[6] In other communities, consumers cross-subsidize the connection costs of poor households,[7] or of all first time connections using technology that would indicate that the user is not wealthy.[8]

In some poor communities the presence of illegal settlements and illegal connections create complications in the definition in the contract of a connection. Government policy often limits the ability of local or national Government to treat with illegal settlements. However, using condominial connections can overcome some of these problems.[9] For example, where an illegal settlement wants to obtain access to utility services, the utility provides a bulk connection to a point outside the settlement. The community undertakes the obligation to pay for supplies which are lifted from the bulk connection by individuals within that community (usually through a low-tech connection). The involvement of the community in billing and payment reduces collection risk. The utility can also, through the definition of a "connection", be encouraged to implement a proactive program for the regularization and conversion of illegal connections, this will allow the use of existing technology for connections but reduce the number of leaks, losses and injuries from badly designed connections.

A less subtle mechanism for encouraging the connection of poor households is to create an artificial priority, for example defining the connection roll-out schedule to include a larger proportion of poor areas. Penalties would then be assessed for failure to achieve the required connection rates for poor households. This negative incentive encourages the utility to endeavor to avoid the obligation and qualify profitable connections as poor households, even if a more objective evaluation might disagree. A positive incentive, for example a bonus paid for each poor household connection made, if designed properly, can encourage the utility to connect as many households as possible that can be characterized as poor, though the financial implications for the entity providing the subsidy (the consumer or the taxpayer) may be significant.

Ownership

6 See for example the support provided by the Swiss aid agency to the communities of La Paz and El Alto in Bolivia and the work of the Global Program for Output Based Aid – www.gpoba.org.

7 See for example the first time connection fund in Dakar, Senegal.

8 See for example the first time connection fund in Dar es Salaam, Tanzania.

9 See for example the delivery of services to illegal settlements in Manila and Buenos Aires. In these two examples, local NGOs provided the design and management of the scheme.

While programs that encourage connection alone of poor communities are obviously beneficial, additional benefits can be obtained by ensuring that local communities buy-in to the connection policy. This ownership can address longer-term management issues (under the premise that people who see themselves as "owning" assets will take better care of them). Ownership can be achieved by keeping communities involved in the decision making process around connections, the technology used, the methodology used and the selection of households to be connected. This ownership can also be achieved through the use of local (in-kind) labor and the sharing of connection costs by the community.

Monitoring/Accountability.

Local ownership of connections can also assist in the monitoring of the installation of connections, the maintenance of those connections and the sustainable delivery of services. Electricity connections are much easier and cheaper to make than other utilities such as water and sanitation, but if made wrong they can result in serious injury and damage. Communities can help monitor the connection of electricity services if they are aware of the connection schedule, know how the connections are to be made and understand that it is in their interest to ensure proper installation and management of those installations.

Both the public and private sector parties in the Nowatta project were keen to implement a program to increase the conversion of illegal connections into tariff paying utility consumers. Illegal connections are an important part of the cause of leaks and unaccounted for water; while their conversion supports increase revenue streams for the utility. In Nowatta, illegal connections had become the norm if not an accepted method of obtaining services from a slow, inefficient state run utility. Punishing those not paying their tariffs on time would prove difficult and politically unpopular. For this reason, illegal connections were given a 12 month amnesty during which those with illegal connections could have them converted to formal connections without penalty. The amnesty period failed to encourage conversion of illegal connections since the private operator was distracted during those first 12 months by more fundamental questions of reducing operating costs and addressing deficiencies in the tariff collection systems; and therefore failed to connect many of those requesting conversion of illegal connections. This resulted in a reduction of public trust in the utility.

4.3 Dispute resolution

Dispute resolution comes in many sizes and shapes; in many flavors. Just as the State provides a number of different courts and tribunals and other mechanisms to resolve disputes that might arise, private contracts also have a series of mechanisms to address disputes as soon as they arise and at least before they become destructive to relationships or society. For example, a contract will generally provide for early interim resolution to avoid any delays to contract performance, and final resolution after a more prolonged and exhaustive process. The private forms of dispute resolution will range from the most non-contentious, non-binding forms of facilitated negotiation, to formal, contentious and binding arbitration.

It is often tempting when putting a project together to ignore the possibility of disputes arising. However, large infrastructure projects are ripe for complex and often debilitating disputes. For this reason it will be worth developing dispute resolution procedures to suit the project's requirements.

Dispute resolution mechanisms in contracts can create a number of different social policy implications, including access to services for the unserved, ownership and monitoring/accountability. The influence of contractual dispute resolution mechanisms in these areas is similar. It relates to the availability of information and the limited opportunity for other stakeholders to obtain information or consult in decision making processes. The contractual dispute resolution mechanism will focus primarily on the needs of the parties. In particular, contractual dispute resolution mechanisms often endeavor to keep disputes, and the information that may be gathered during the resolution of disputes, confidential. This may not correspond with transparency and monitoring requirements, nor the desire to share information amongst stakeholders. Contractual dispute resolution mechanisms also limit access of stakeholders to dispute resolution processes. Where key issues or concerns are addressed through contractual dispute mechanisms, consumers and other key stakeholders may not be permitted to take part in the proceedings or receive any information about those proceedings.

In the Nowatta project, the regulator had the right to set tariffs and service standards. The regulator's discretion was limited only by the primary and secondary legislation that gave then regulator his mandate. The private investors were not willing to bet that the regulator would use his discretionary powers to set tariffs and service standard levels in a commercially sensible fashion. Therefore the contract included a compensation mechanism to protect the private sector

if the regulator chose to implement tariffs or service standard levels in a manner different than that agreed in the contract. In addition the Government of Nowatta provided a partial risk guarantee for failure to fulfill these compensation obligations. Soon after contract signature, the private investors concerns proved well founded. A combination of up-coming elections and an inexperienced, if well meaning, regulator resulted in rising service standards and decreasing tariffs, despite a desperate need for additional revenues into the utility to fund urgent asset refurbishment. The presence of the partial risk guarantee moved the debate on proper tariff levels and the need for capital expenditure away from the public forum of regulation to te private forum of the partial risk guarantee and arbitration.

5. Change

Social policy evolves. Contractual mechanisms designed to implement social policy must then change with social policy. The mechanisms within the contract that allow change must be sufficiently flexible to allow whatever new direction social policy might take, while protecting the financial viability of the underlying commercial arrangement and the return on investment promised to the private sector. Also, change in social policy and the subsequent change in the contract should not be permitted to undermine existing successful processes. Where progress has been made, change in social policy should not compromise the sustainability of achieved benefits.

5.1 Source of Change

There are a variety of sources of change in social policy or changes that might affect a utility project or the associated parties, and therefore the nature of implementation of social policy. The most important sources of change for utilities are political, demographic and economic/commercial.

Politics

Politics by nature assumes change. Social policy can change significantly over short periods further to political change. Mechanisms to address dramatic political change and violence are equally difficult to design into a utility contract.

In contrast to dramatic political change, loss of political interest can have equally dramatic effect. Political support is often necessary for utilities, which deliver public services and may be subject to intense public scrutiny. Failure of political powers to support or protect the utility may create tensions that make it difficult to implement social policy. For example, utilities are generally mandated to disconnect consumers who fail to pay their bills. The social policy behind these powers is the desire to penalize behavior that is damaging to the community as a whole, or at least the community of consumer. Some exceptions may exist for poor households or institutions that provide special services, such as hospitals, where the disconnection of utilities is likely to have dire consequences. However, public frustration or interests may cause resistance to the utility's power to disconnect. If the utility loses its political support, the police may have difficulty upholding the utility's right to disconnect which then changes significantly the financial position of the utility and places additional burdens on paying consumers.

Demographics

Contracts and social policy are established based on the location and condition of certain communities at a given time. If those communities are displaced, or their nature changes over time, the original intention of the contract or social policy may no longer be relevant, or it may be entirely inconsistent with the original intention. In particular where the needs of a community change (e.g. a community becomes more industrial than residential), or the wealth base of the people in that community changes, the social policy and the contractual mechanisms will generally need to change with them.

Immigration (both legal and illegal) can have a significant impact on demographics, and possibly on social policy implications. The nature of immigration and the relative condition of immigrants will influence the nature of the implementation of social policy. This will change over time, and from region to region. For example, social policy often applies different rules for recent immigrant, long-term immigrant and illegal immigrant communities.

Economic/Commercial issues

The macro-economic context of a country, such as the value of the local currency as compared to other associated currencies (in particular where Government or domestic debt is denominated in foreign currency) or the rate at which the Government is able to borrow money,

will change over time. Dramatic changes such as those experienced by Asia at the end of the 1990s or Argentina in 2000 can significantly influence utility contracts and the context in which social policy is implemented. Understanding of these macro-economic shocks has improved and contractual mechanisms can be designed to adapt accordingly, but often the question is whether the resulting tariff or service regime is affordable or acceptable to consumers. These kind of emergency situations often call for external (Government, donor or IFI) intervention to soften the impact of change.[10]

Similar changes may occur at a micro-level, to the parties involved in the utility or the utility's immediate context. For example, the cost of fuel for an electricity utility that relies on thermal generation may rise. Most private sector utility projects are designed to address such changes, but often the implications on social policy are not considered. For example where tariff levels are subsequently raised to a level such that the poor cannot afford electricity for heating during the winter, or farmers cannot afford the cost of pumping water for irrigation, then the policy embedded in the contract may need to be adjusted, to achieve the same goal of financial viability while protecting the poorest consumers, but in a manner not contemplated in the drafting of the utility contract.

5.2 Mechanisms for Change

The first challenge is to identify change, and once change is identified for the contract to provide mechanisms that encourage the parties to address those changes. Change is often gradual and organic. All too often parties ignore change hoping that its repercussions will not actually affect them or the utility. Also, the change and its implications may not be identified. Without a clear understanding of the change and the possible effect it will have on the utility, on the way the contract implements social policy may be insufficient.

In some cases a very mechanistic formula can be agreed in the contract, for example for emergency or periodic tariff resetting, taking into consideration all relevant surrounding circumstances. The challenge is designing a mechanism that will adjust to all the different changes in social policy or the circumstances surrounding social policy that could have a sufficiently serious impact on the contract to merit change in the contract terms, and how to

[10] See for example the transition subsidies available through the Global Program for Output Based Aid, www.gpoba.org.

ensure objectively that any changes implemented in the contract terms do not alter the spirit of the original agreement between the parties as embedded in the contract.

Change can be implemented by law through change of legislation or secondary legislation/regulation where permitted. Any change in law and any change in circumstances or social policy must also be contemplated or permitted by the contract. It is uncommon for the contract to stop the public sector from implementing changes in social policy, or its implementation. Many of these changes will be binding on the private sector even if the contract says otherwise. However, the contract will often protect the parties from the implications of the change and may therefore alter the implementation of social policy.

Whatever the instrument that implements the change and enforces it on the project, the contractual mechanism must be able to adjust to that change while maintaining the commercial viability of the project. Change in social policy without considering utility viability (political, economic, social, financial and commercial) can destroy the project. Equally, the failure to provide flexibility for the parties to address change can increase the likelihood of renegotiation or failure of the project.[11]

There are two basic approaches to addressing change, first is to insulate the private sector from the change and look to the public sector to implement the change (undertaking full cost and risk). It may be better value for money for the public sector to implement such changes or it may not be practical for the private sector to try to build the skills and resources needed to implement the change. Or, the public sector may prefer for the private sector to implement the change and therefore the terms of the contract need to be adjusted to compensate the private sector for the cost of the additional services. It may also be that the change reduces the cost to the private sector of its services and therefore the contract adjustment reduces the compensation paid to the private sector.

The contractual mechanisms needed to address changes will depend to a certain extent on the local political, social and judicial functions. Mechanisms for change include one or more of the following, often in combination.

[11] Guasch, J. Luis, Granting and Renegotiating Infrastructure Concessions: Doing it Right (World Bank 2004).

Parties agree in advance

The contract can include a mechanism that automatically changes the contract in the event of a change. This is often the case for changes in tariff levels, for example, at certain events or periodically, based on externally driven indicators such as consumer price index or the exchange rate between two relevant currencies. Contractual formulae are inflexible, they do not tend to adjust to external circumstances not specifically contemplated in their drafting. But, contractual formulae are simple and easy to apply (if well drafted). They also provide a clear basis for later negotiations of any changes or circumstances not contemplated by the contract.

Parties agree as and when

The contract may provide that in the event of a change the parties will convene to discuss necessary changes.[12] The mechanism for dialogue may also include an indication of the basis on which these discussions will be held, for example tying the parties to the spirit of the contract. These discussions may include the assistance of a facilitator or expert to provide an external assessment of the need for change and to bring the parties to a mutually acceptable agreement.

In the event that the parties fail to agree a change, they may choose to empower a third party, for example an arbitrator, to decide for them whether or not there should be a change and what that change should be. It is usually preferable to set out the basis for the decision by the third party as the third party is unlikely to be as familiar with the nature of the relationship between the parties or the needs of the utility as will be the parties.

One party or an identified group of parties decides

The power to decide a change may instead be given to one or a group of parties. This may be most appropriate where a given change will have a large impact on the specific parties but little impact on other parties. It is therefore sensible to give control over such changes to the parties that will be affected. This change may be limited to circumstances in which the deciding parties have first consulted with other parties or stakeholders, or the methodology for decision making or basis on which a decision can be made may be limited. This would allow the other parties to challenge the change if it is not made in accordance with such methodology or on such

[12] It should be noted that Anglo-Saxon and some other legal systems will not enforce a contractual provision that is an "agreement to agree", thus an undertaking by the parties to discuss an issue and agree a change may not require them to agree a change.

a basis. For example, the private party may be allowed to change the standard of technology used to provide connections to poor communities unilaterally where a more cost effective method is found but which delivers an "equivalent" service. Other stakeholders may be given the right to challenge a change in technology that does not achieve an "equivalent" service.

Third party decides

It may be that the parties chose not to be involved in the change decision, but instead outsource that decision to a third party, possibly only after consultation with the parties and/or other stakeholders. The third party is likely to be given a specific mandate or basis on which decisions can be made, and a methodology for decision-making. This will allow the parties to monitor the third party's decision making and challenge any change that does not satisfy the third party's mandate. The mechanism to challenge the decision may use an existing dispute resolution mechanism, such as a court of law or arbitration, or it may be given to a special mechanism used only for this third party, for example expert determination by a specialist in the field in question.[13]

It may be preferable, where the likelihood of change is high, for the third party decision-maker to be involved in the project over the life of the project or during the period in which the change is likely to happen. This is a more expensive option given the need to pay the third party to remain involved in the project and knowledgeable of the circumstances surrounding the utility, but it will expedite change request administration and allow the third party to make decisions with a greater base of knowledge and familiarity with the utility and the parties.

A common example of a third party decision-maker would be a regulator, whether empowered by contract or by law. The regulator can play a role in deciding what changes need to be made and when and is involved in the project from commencement. As discussed above, the contractual mechanisms associated with change by the regulator will need to be considered carefully to ensure that they do not unnecessarily restrict the regulator's ability to make changes but also such that the regulator is bound by the basis agreed by the parties on which he is empowered to make changes. In many legal systems, regulators cannot be bound by contract to

[13] As noted above, contractual disputes may deny non-party stakeholders from information about disputes or consultation on specific issues.

implement their regulatory mandate in a certain way, this legal principle is known as "fettering the discretion" of the regulator.

6. The Process of Contract Design

In addition to the complexity of the design of contractual mechanisms to ensure the effective implementation of social policy, the process itself of contract design is fraught with challenges. There are three key phases of contract design: (1) the original design of the contract by the Government, though with greater or lesser involvement of the private sector investor; (2) negotiation of the contract with the preferred bidder, the contract can change significantly during this phase; and (3) implementation of the contract in particular adjustment to changed circumstances, new facts or the discovery that the facts on which the parties originally relied are not quite as anticipated.

The contract design process brings together a number of different parties, including representatives from the line Ministries, the Ministry of Finance or Economics, foreign investors/contractors, local investors/contractors, and financiers. Each party responds to a different set of incentives and agenda. Significant effort is often needed to bridge the cultural and technical gaps between the representatives from the different parties and bring them to a common understanding. Into this melee of differences, social policy must find a context and base of power from whence to ask for changes to the politically and commercially driven design advanced by the key actors in contract design.

One of the keys to implementing social policy into the contractual arrangements used for private sector participation in a utility project is involving someone in each of these phases of contract design who understands social policy implications. This is rarely the case. Contract teams usually include commercial lawyers, financial experts and engineers from the private company and from the relevant Ministries. These individuals may not implement, or provide for, social policy in the contract, more out of ignorance than neglect.

In order to be accepted into the inner sanctum of contract design, the social policy expert will need to demonstrate an ability to implement social policy in the most commercially sensitive and practical manner possible. It is not enough for the social policy expert to be accepted into the design function, but he must also carry negotiating strength sufficient to drive forward the social policy agenda. Where the social policy expert is not otherwise a key member of one of the

negotiating teams, he may also need to provide something that adds value to the project before being invited to join the negotiations, for example to the extent the Government will provide subsidies or wants to create a cross-subsidy function these mechanisms may be managed by the social policy expert. Equally, social policy experts who understand the commercial arrangements and the underlying contracts need to be involved during implementation and change management.