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Entry of Multinational Water Companies in Local Markets: Survival Strategies for Small Water Utilities

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About the Author



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Abstract

This paper examines the survival strategies of a small water utility seeking to involve a multinational company in the delivery of water and sanitation services in the local market. The water utility under consideration, the Water and Sewerage Company Inc. (WASCO) is located in St. Lucia, an island nation, with an area of 238 square miles and a population of 165,000. Despite years of effort to improve the performance of the public water company through conventional institutional strengthening programmes and twinning arrangements, WASCO continues to perform poorly, with unreliable supply of water, low coverage of sewerage, poor financial performance, and low level of capital investment. In response to this situation, the Government of St. Lucia has decided to open up the ownership and management of the water company to the private sector, with the objective of improving the reliability and the quality of water and sanitation service delivery on the island. The provision of a reliable water supply is likely to stimulate investment, economic growth and employment.

Introduction

There is the general view that most multinational companies are struggling with existing water contracts in emerging markets, with policies to withdraw from less profitable markets, and with little enthusiasm for expansion except in a few large markets. The available information indicates an extremely high failure rate for such contracts like private concessions and long-term BOTs. As a result, some reputable water multinationals have taken the strategic decision to reduce their exposure in developing countries. This is being accomplished by exiting from contracts particularly concessions, which are seen as not profitable or too risky.

Such a decision taken by key multinationals to exit from investments in developing countries represents a major shift in strategy. The multinational companies appear to be placing their best efforts on those water investments that carry low levels of risk and can generate reasonable profits, while reducing company debts. The objective of these multinationals appears to be to increase profitability, with a target of at least 11% return on capital, and financing all investment and dividends out of those profits, without borrowing.

Against this background, the Government of St. Lucia has taken the policy decision to open its water market to a consortium of private investors, locally, regionally and internationally. The shareholding

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arrangement will soon be on the table for private consumption. The structure will be based on the sale of a controlling stake in the proposed new water company to private investors.

The Government's decision raises a number of questions: Why should a multinational company be willing to enter into the water market in St. Lucia? What is the driving force, in the case of the multinational company, for competing internationally? How should the multinational company enter the water market – Is it through a management contract, a lease, a concession, a hybrid structure, or some other arrangements? What should be the exit strategy for such a company? Will there be high exit barriers for a multinational company that has made substantial investments in the water sector? Are there competitive pressures to globalize in the water sector?

Key Challenges Facing the Water Sector

From a financial perspective, WASCO is not an attractive water utility. Potential investors need to be convinced that a restructured water company can generate sufficient cash flow through efficiency measures and otherwise. The treatment of existing debt including additional debt to bring the water supply system to an acceptable level is a major challenge. The utility's assets need upgrading and capital investment must be injected into the water utility immediately. A capital improvement programme to implement critical investments is ongoing, supported by loans from the World Bank and Caribbean Development Bank loan in the sum of USD7.9 million and USD4.0 million respectively.



WASCO Staff discussing strategies under one of the critical investments; the metering program, funded by CDB.

The water sector faces the prospect of further increase in demand for water as a result of a booming tourist industry and overall economic upturn. The island has a low sanitation coverage which will be an increasingly important issue as the tourism and other sectors continue to expand. Additionally, the water sector expects peak demand as a result of Cricket World Cup 2007.

WASCO does not have a good public image. Consequently, there is a need for improved customer goodwill through public relations and better service. It is also necessary to promote public understanding at all stages related to the partnership with a multinational water company.

Survival Strategies for the Water Utility

Based on the assumption that multinational water companies will be selective in finding new opportunities for growth in the water market, the question arises as to how WASCO can survive in the market place. Given the recent retreat of the major water players from the international market, it is anticipated that interest will most likely come from an operator already active in the region and/or an operator keen to gain a foothold in the Caribbean market. Of course interest is also likely to come from smaller companies that have recently emerged from Europe and particularly Latin America.

Niraj Dawar and Tony Frost, in their article “Competing with GIANTS-Survival Strategies for Local Companies in Emerging Markets”, state that the pressures to globalize in an industry are dictated by two factors, the strength of globalization pressures in an industry and the degree to which a company's assets are transferable internationally. These two factors can guide strategic

thinking. According to Dawar and Frost, if globalization pressures are weak, and a company's own assets are not transferable, then the company needs to concentrate on defending its turf against multinational incursion. A company employing such a strategy is called a **Defender**. If globalization pressures are weak but the company's assets can be transferred, then the company may be able to extend its success at home to a limited number of other markets. That sort of company is an **Extender**. If globalization pressures are strong, the company will face bigger challenges. If its assets work only at home, then its continued independence will hang on its ability to dodge its new rivals by restructuring around specific links in the value chain. Such a company is called a **Dodger**. If its assets are transferable, though, the company may actually be able to compete head-on with the multinationals at the global level. A company which falls in that category is called a **Contender**.

A careful review of these four strategies is of paramount importance, as it will help prescribe the most viable option for St. Lucia's water utility. The strategic fit for the local water company, where the competitive assets are customized to the home market and where there is much pressure to globalize in the industry is for WASCO to **dodge**. Consequently along the value chain, the Government is faced with two options: (1) Sell out to a multinational (2) Enter into a joint venture with the multinational, in the form of a Public-Private Partnership (PPP) arrangement. The first option is not a rational choice given the social nature of the service. It is given that the Government should remain the custodian of the water assets in order to protect the public interest. Therefore, the most viable option is for the Government to enter into a partnership with a strategic investor or consortium of investors, with a water operator being part of that partnership.

Market Interest in the Strategic Partnership

An Investor or Market Survey was conducted by the then Stone and Webster Management Consultants in 2003, as part of an Investment Feasibility and Financial Strategy for Private Sector Participation in the Water and Sewerage Sector of St. Lucia. The specific objectives of the Survey were to:

- Stimulate interest in the marketplace for the upcoming PPP marketing opportunity. In this case, the Survey was a marketing instrument; and
- Provide experienced water companies and potential investors with key indicators on the marketing opportunity and to obtain their initial feedback on the strategy. The responses were used to adjust the strategy based on the overall level of interest and the specific issues identified in the marketplace.



Workshop session conducted by Stone & Webster on "Investment Feasibility for Private Sector Participation (PSP) in the local Water Utility."

The Investor Survey revealed that the majority of private investors contacted, recognizing the sensitivity of water investments, preferred a Joint Venture arrangement with the Government of St. Lucia as a partner. Even more important, a polling of St. Lucians in 2005 revealed that a solid majority expected service to improve with private sector participation in the sector, although they preferred a continued Government role. This revelation calls for a public-private partnership.

In sum, a large majority of St. Lucians supports the PPP arrangement. The partnership will result in a massive inflow of capital into the water sector; a sum that the public budget alone could not support. The PPP structure locks in the Government of St. Lucia as a partner in the decision making process. A water sector regulator, the National Water and Sewerage Commission, is now

in place despite a tough inception process. The regulator is tasked with ensuring that the investments are made and services are improved according to specific performance targets. The regulator must also ensure that the new PPP Company does not finance all of its investments with equity and cash flow from operations only. This happens to be the case with some Joint Venture arrangements elsewhere in the sector. To allay such a concern, a license will spell out the investment obligations of the new company. Additionally, a performance bond will be called in if the private sector partner does not meet its investments commitments or operate in accordance with its operating license.

Now that initial feedback has been obtained from the marketplace, the next step is to decide on a transaction structure that attempts to match the policy objectives of the Government of St. Lucia with those of the market, and the selection of a good partner (or partners) that shares a common vision for the sector.

With respect to the partnership structure, Government envisages the placement of a sixty percent stake in the water and wastewater sector with the private sector. A new entity will be created with the winning bidder acquiring this stake through capital contributions. The Government will retain 20% of the shares while the government anticipates selling the remaining 20% to a regional institutional investor that operates on a commercial basis. The acquisition of the State's share will be purchased through in-kind contribution while the institutional investor's share would be financed through cash contributions. It is anticipated that a portion of the shares in the company will be floated for the general public's consumption once the water company has been turned around.

Santander Investment S.A, the Transaction Advisors, have yet to fully test market appetite for the proposed partnership structure. However, Santander has conducted due diligence and a diagnostic of NWASCO, and has highlighted a number of issues – both positive and negative, which need to be taken into account and brought to the attention of international water companies and potential investors.

The Benefits of the Strategic Partnership

Benefits of a PPP arrangement abound to both the public and private sectors. To begin with, the partnership will result in a massive injection of capital into the water sector that the public budget could not support by Government going alone. Although finance from donors, development bank loans, commercial bank loans, bonds and operating surplus is, in principle, equally available to public and private sector operators, the Government may not want to expose tax payers to additional debt. Hence, the private partner can bring in the private finance and equity finance from private shareholders.

Additionally, the PPP structure keeps the Government at the table as a partner in all decisions. Government's involvement, license requirements and private sector bonds (insurance) will protect the interests of consumers, while a fully private concession might preclude the Government from participating as a partner. The strategic alliance will fill the gaps in technical expertise and knowledge of the local market, especially if the management team consists of a mix of expatriate and local managers.

Also, the Government will own 20% of the new water company through the contribution of a select set of assets (including net operating assets, the main office building and existing vehicles). The entire existing water infrastructure of St. Lucia, including the Roseau Dam and works

currently under construction, will remain the property of the Government of St. Lucia. In sum, the physical assets already belong to the public, and new assets are not transferable.

Finally, the Government will sign an evergreen service agreement with the new company for the exclusive right of use of the water infrastructure including the Dam, under a usufruct arrangement (the right to earn revenue from the set of assets contributed by Government). The new company will be responsible for their operation and maintenance. In short, the PPP arrangement does not involve the sale of collection areas such as the Dam, the mains, the treatment plants or any large assets owned by Government. Instead, the new partnership – Government and private sector – is “buying” the right to operate these assets.

Conclusion

Joint ownership has certain drawbacks, and resolving them amicably is the best solution. The partners might have different motives and conflicting objectives. The partners might disagree over investment priorities to the extent that the majority shareholder would seek to invest in projects with the greatest potential for revenue. One partner might want to reinvest earnings for growth and the other partner might want to declare more dividends. The partners might disagree about policies or courses of action. Recognizing that the PPP arrangement must benefit both sides, the partners must deliver on their commitments, once agreements are signed.

Despite any drawbacks, the public-private partnership provides an opportunity for attracting investments in system improvements and expansion. The International Company will enjoy a protected market position in an industry that contributes to the conditions of a natural monopoly, especially for water capture, transmission, and treatment.

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