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Corporate Governance and the Collapse of Privatization Deals:
The Case of Water in Buenos Aires

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Abstract

This study explores the role of corporate governance in privatized water companies in emerging economies with a review of a case from Argentina. Very few developing countries have privatized their water resources. Important externalities imply that government participation in the business of water will be greater than in other public utilities. There is much that is unseen and therefore unknown about water, including its buried infrastructure, which implies that information problems will be greater than in any other privatized business. Private participation will be less extended and the contracts with private parts will tend towards periodic renegotiation. In this context the role of governance mechanisms are of critical importance.

The analysis of the effectiveness of governance mechanisms in the privatization of water services is done through a case study analysis. The city of Buenos Aires in 2006 became one of the few cases where, in less than fifteen years, water services were privatized and then re-nationalized. The failure can be related to the lack of a clear regulation with a strong and independent regulatory control body coupled with the reluctance of the company to have transparent and open governance mechanisms. In summary the failure can be traced to weak corporate governance, a common problem in emerging economies eager to attract private investors.

Keywords: Privatization, corporate governance, international financial agencies, water and sewage, regulatory body, Buenos Aires.

1. Introduction

In recent years, some analysts have seen the growth of private participation in water and have proclaimed it to be a world tendency (World Bank, 1994; Frischtak, 1997). Others, nevertheless, are less sure and are focused on the factors that prevent private participation in water from occurring, as in other natural monopolies. Very few developing countries have completely privatized their water resources, although some have employed concessions, leases, service contracts or outsourcing of services.

Important externalities imply that governmental participation in the business of water will be greater than in other public utilities. The nature of the sector suggests that information asymmetry problems will be more

significant and rents for government and private investors will be smaller than in other public utilities networks. As a consequence, privatization will be less extensive and the contracts with private parts will tend towards periodic renegotiation. In this context the role of governance mechanisms, and in particular the regulatory body are of critical importance; therefore the purpose of this study is to explore the role of corporate governance in privatized water companies in emerging economies.

The analysis of the effectiveness of the governance mechanisms in the privatization of water services is explored here through a case study analysis. The city of Buenos Aires in Argentina is one of the few cases in the less than fifteen years that this process has been taking place where a government has privatized and then re-nationalized water services. The franchise was given in 1993 to the company that offered the largest reduction in water tariffs, but was revoked by the government in 2006. The failure can be traced to the lack of clear regulations and a strong and independent regulatory control body coupled with the company's reluctance to have transparent and open governance mechanisms. In summary the failure can be related to weak corporate governance which we suggest is typical of emerging economies eager to attract private investors. This paper is motivated by the Argentinian experience exposing the impact of fuzzy governance mechanisms in the long term profitability of privatized companies in emerging economies.

This work considers first why private participation in natural monopolies can be desirable then analyzes the ways in which water is different from other public utilities. Control and governance mechanisms are explored in general and then described in the case study. Then the experience in Argentina is presented followed by analysis and conclusions.

2. Privatization of Natural Monopolies and Control Mechanisms

Water is a natural monopoly, where the average long-term costs imply that a single business should serve the whole market, but unless that business operation is regulated, the service provided will be restricted to the level that maximizes its income. While new technologies have reduced the characteristics of natural monopoly in other sectors, no such development has occurred in water. In urban areas with dense populations, the only way to bring water and to remove sewage residues from houses has been, and probably will continue to be, through a system of pipes that are costly to install and maintain.

The existence of a natural monopoly justifies governmental intervention, but not necessarily governmental property. Shapiro and Willing (1990) and Schmidt (1996) maintain that state-owned property reduces asymmetries of information, but Laffont and Tirole (1993) emphasize that lack of information regarding the operations of private enterprises can be good, if the regulator promises not to expropriate the investment. In theory another advantage of state property is that a benevolent state would use the power of ownership to champion public welfare over profit maximization, but a benevolent state is a mythical creature only found in economic texts. In practice governmental officials can act to maximise their own profits (Shapiro and Willing, 1990), or those of the politicians or interest groups. Theories of public selection (Niskanen, 1971) also maintain that the managers of the public good, bureaucrats and politicians can use its control of state run businesses to improve their own interests, instead of improving the efficacy of the state run business, in which case any positive effect in the welfare would be a secondary motive or an unexpected consequence. In contrast, McCubbins, Noll and Weingast (1987) assert that political players design regulations ensuring that the interests of their voters are protected.

Private owners will maximize their well-being through earnings and profits; they would have a stronger incentive than governmental

bureaucrats to have control over management and to maximize earnings due to the fact that they have legal rights on any surplus that the company generates; normally identified as “residual claims”. As a result, a private monopoly not properly regulated will operate effectively, charging high prices and meeting only a portion of the demand. As Vickers and Yarrow (1991) observe, much depends in the nature of the regulatory game between company and government. In fact, regulation might reinforce, rather than ameliorate or resolve government officers' problems when they run the business on their own interest, a challenge thought to have been addressed through privatization. The intention of this paper is not to discuss the alternative ways to operate a natural monopoly, as this topic has been covered extensively by economists (Demstez, 1968; Williamson, 1976; Goldberg, 1976; Crocker & Masten, 1998). The alternatives can be summarized in table 1.

Table 1: Contractual Arrangements options for Water service companies

	Asset property	Operations and maintenance	Investment	Operations financing	Capital Financing
Government department or agency	Government	Government	Government	Subsidies	Transfers
State run company	Government	Government	Government	Royalties	Guaranteed equity
Management contract	Government	Private	Government	Government	Government
Lease	Government	Private	Government	Private	Government
Concession	Government	Private	Private	Private	Private
Private company	Private	Private	Private	Private	Private

Source: adapted from World Bank (1994)

A way in which water differs from other natural monopolies is in the presence of important externalities which imply that government participation is needed even when the sector is competitive. It is of public interest that water is extensively available and affordable; also there are

important health effects not only in the clean water but also in the drainage of dirty water that can explain why the two seldom are separated (Crocker and Masten, 1998). The water service, if not appropriately located far away and treated, can contaminate water supplies, while a system of sanitization only can operate if there is an adequate supply of water to empty it.

The externalities associated with water are a reason for regulation but not necessarily for maintaining the property. There is little evidence that the water businesses run by the state have protected health and the environment better than private enterprises, and there is some evidence exists that have been worse polluters than the private enterprises (World Bank, 1995). Besides the externalities, the second challenge for private participation is the problem of information on water. Consumers cannot easily ascertain if the water is safe to drink, due to the fact that many dangerous contaminants do not affect the appearance, smell or taste of water. This justifies the regulation of quality and the supervision of health effects, but not necessarily state ownership of the water company. One problem having adverse effects on private investment and regulation is the fact that the majority of the infrastructure network is underground and therefore invisible. The hidden nature of water assets means that potential private investors find it burdensome and time consuming to evaluate the quality of the water network before submitting a bid. Similarly, for regulators it is difficult to determine how well private companies are maintaining the system. Such problems of unknowability increase the risk that the regulator or private supplier will renegotiate the contract later, when more information is possessed. Agency theory conceptualises the design of optimal contracts. Although, agency theory can model incomplete contracts, in real situations the concept of bounded rationality is more useful¹. Under this perspective, human beings (regulators and managers especially) cease to be perfect individuals with an infinite capacity to process information, and have to find ways to manage unknowns.

¹ “The capability of the human mind for formulating and solving complex problems is very small compared with the size of problems whose solution is required for objectively rational behavior in the real world” (Simon, 1957, p 198).

A third difficulty is related to price. Crocker and Masden (1998) emphasize that to attract investment a price needs to be set that will allow private investors to recover their costs, but not so high as to increase risks of illness or death caused by people not paying for water services and therefore opting for unreliable alternatives. The regulator's competence to assess this assumes that external factors that affect the price of the company are in some way correlated (Clarke and Cowan 1998), but given the localized nature of water this is often not possible.

It is probable that profits are lower in water than in other public utilities because the externalities and the information problems enlarge the regulatory risk in a sector with large capital costs that are almost completely sunk costs. This can explain why we have seen so few experienced international companies bid for franchise contracts. In summary, where private participation is permitted we expect that the pricing formula and the problems of information asymmetry will generate frequent contract renegotiations.

2.1. Monitoring of Privatized Companies

Jensen and Meckling (1976) define an agency relationship as a contract under which one person (principal) engages another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent. In the case of privatized companies the principal or the government delegates the day-to-day decision making to the agents or managers of the privatised company. Managers are charged with the responsibility of using and controlling the economic resources of the firm. However, they may not always act in the best interests of the government or stakeholders partly due to adverse selection and moral hazard. The government and stakeholders must therefore monitor the activities of the managers to ensure that they live up to the provisions of their contracts (Goddard et al., 2000).

To guard against management failures, Moldoveanu (2001) argued that stakeholders (government in our case) should enact ratification, monitoring and sanctioning (reward and punishment) mechanisms. He defined ratification mechanisms as those used to validate the decisions of

the agent, in giving final approval or veto for an initiative or directive or actionable plan of the agent. Monitoring mechanisms are designed to observe, record and measure the outputs of the efforts and intentions of the agent. Sanctioning mechanisms are designed to provide the agents with selective rewards and punishments to motivate them to act consistently with shareholders' interests.

Power (2002) argued that the primary means of monitoring is through annual accounts whose reliability is enhanced by the audit report. However, accounts may be inadequate for monitoring purposes due to information asymmetry. Managers, who have more information than the government, stakeholders or auditors, prepare the annual accounts and may be unwilling to disclose private information for fear that it may be used against them. The nature of the audit is such that omissions or distortions may not be detected or reported to the government and stakeholders. In addition, monitoring involves costs, which the government and stakeholders may be unwilling to bear.

To monitor the management of privatized companies in emerging economies, governments and stakeholders have traditionally relied mostly on the regulatory body but to a much lesser extent on the corporate governance mechanisms that are mandatory for public companies. Previous studies consistently suggest that disclosure levels in developing countries are low (Shleifer and Vishny, 1997; La Porta et al., 1999; Rabelo and Vasconcelos, 2002; Tsamenyi et al., 2007). This defect can be traced to the recommendations prepared by multilateral organisations such as the International Monetary Fund and World Bank which focus mostly on regulations and regulatory bodies' competences.

This study examines the governance policies and practices used to monitor the management of one privatized water company in Argentina, and will report on data collected to evaluate the following propositions:

Proposition 1: the monitoring of privatized companies' management in emerging economies is done mostly by a regulatory body.

Proposition 2: the monitoring of privatized companies' management in emerging economies is reliant mostly upon a

set of mandatory governance mechanisms.

2.2. Corporate Governance and Regulatory Bodies

Vinten (1998) stated that corporate governance is not new. It dates back to when incorporation with limited liability became available in the nineteenth century, with the concomitant need for legislation and regulation. Recent debate has however focused on more specific concerns. These revolve around the accountability of those in control of companies to those with interest in corporate success, normally the stakeholders.

There has been extensive discussion of corporate governance during the 1990's but views differ over what it is and how it might be improved. Corporate failure and scandals have led to demands for reforms and better regulations particularly in the field of corporate governance. In the UK a number of issues in the early 1990's, most notably the collapse of the Maxwell business empire, stimulated discussion and debate about structures for controlling executive power (Power, 2002). A code of best practice was developed by a committee chaired by Sir Adrian Cadbury, 'the Cadbury Code' in December 1992 which included recommendations that companies establish audit committees comprising independent non-executive directors. Power (2002) argued that as sub-committees are independent from executive management, they provide the natural reporting constituency for internal and external auditors. The Cadbury Code was later adopted by the London Stock Exchange as a condition of registration, and the public sector implications have been widely debated (Power, 2002).

A key aspect of any regulatory body in water services is how to strike a 'balance' between public and private interests, thus enabling the corporation to maintain reliable technical and service standards at affordable tariffs for all families served. This balance is required if the different objectives of the key players are to be reconciled in a sustainable way. When a government itself is responsible for all aspects of the infrastructure, achieving a balance between the various players might be regarded as less vital, the assumption being that the Government will

act in the best interests of all. Governments can, as sole provider, determine what is needed, although this is increasingly open to debate as the voice of the customer is seen as increasingly important. In the search to find more effective institutional set-ups for infrastructure provision, there is increasing emphasis on separating all the possible roles so that better incentives can be designed for each party and performance can be scrutinized more effectively (Lanti, 2006).

The main balance to be struck is between the profit-motivated private sector and the public interest, i.e. to enable an affordable service that serves the majority of the population. If this is not achieved, the service will not be sustainable, the private sector may withdraw, on-going disputes will occur and the promise of a greatly improved service may not be realized.

3. Evidence from Argentina

One of the best aspects of the privatization process of the 1990s in Argentina was the design of a really rigorous set of legal procedures, although it was weak in terms of regulatory bodies and silent regarding corporate governance mechanisms. The particular unfolding of this process was later repeated in countries throughout the region. It seems increasingly clear that establishing a regulatory framework before privatization improves the outcomes of the process but a comprehensive set of corporate governance mechanisms guarantees successful operation for the long term. An example of the intersectorial experience in Argentina seems to confirm this; Gas and Electricity, where the law established the regulating framework before the restructuration and the privatization, showed better performance and less controversy than the privatization in telecommunications, transportation and water.

3.1. Electricity Privatization in Argentina and the regulatory body: a good example

The legal base of the process of restructuration is detailed in the

1989 laws that outlined the global reform of the Argentinian State. A law (Law 24065) outlines the regulatory framework for the electric sector, which Congress approved in 1992. This law prepared the general objectives for the sector and created an independent regulator in charge. The Congressional discussion and approval guarantee commitment to changes and ensure their stable implementation. The general objectives were detailed in law 24065 and now are found in the majority of similar laws in Latin America, which not only guide the global plan of the regulatory framework but also the decisions taken by regulators.

The law also set up an independent regulator: the National Regulator of Electricity (ENRE). The Agency's board has 5 directors appointed by the national government through the Secretary of Energy. The positions of president and vice president are based on a public and open competition. Candidates are required to either be engineers or economists with specific experience. Final selection was based on interviews conducted by a private consulting firm (PriceWaterhouseCoopers) that short listed three candidates of those selected by the Secretary of Energy. A third director was chosen in the same way, and also expected to be an economist, engineer or lawyer. The last two came from the proposed list via the Federal Council of Energy that is an agency representing the provinces. The Directors have five year terms of office and can be re-elected. The initial confirmation was arranged in such a way to ensure that that at least one director changes every year. A list of the functions and obligations of the regulatory body is provided in table 2.

Table 2.

Functions and obligations of the ENRE as declared in law 24065

1. to enforce the regulatory framework, the contracts and obligations of public utilities
2. to establish rules and regulations in matters of security, technical procedures and norms,
3. to measure and control the use of water meters, interruption and reconnection of the service, access and quality of service
4. to prevent monopolistic, anticompetitive conduct,
5. to define the basis for the calculation of the tariffs
6. to handle and to control the pricing agreement
7. to publish the general principles to be followed by distributors and conveyors
8. to determine the base and criterion for the allocation of concessions
9. to organize and to carry out the offering, awarding and signing of contracts
10. to organize public consultations
11. to supervise property rights, respect for the environment and public security
12. to take problems that arise to Court
13. to regulate the procedures for imposing sanctions
14. to impose sanctions
15. to publish information and to advise to all players in the system
16. to produce an annual report and to recommend follow-up actions where needed
17. to do what is necessary to ensure respect of the law
18. to collect information on conveyors.

It is important to note that these functions and obligations are imposed and regulated by the law, by the Parliament and not by the Executive branch. This is a necessary, although not sufficient, condition to ensure the independence and responsibility of the regulator. The responsibility can expand depending upon the way in which the agency is financed. The financing of the agency is based on full quotas for all participants in the industry. The ENRE publishes its own budget yearly, and gives all the agents the opportunity to object to it. The budget has to be approved by the Parliament as part of the national budget. Once it is accepted, the ENRE charges the generators, transporters and distributors a rate for inspection and control. The rate is calculated as a percentage of the value of the raw production at wholesale trade prices.

Apart from the regulator's role, another critical element is that all Argentinian electricity companies are public, quoting their shares in the Buenos Aires Stock Exchange. Governance mechanisms required for

public companies in Argentina are comparable to the high standards of the UK and USA, particularly after the reform of the year 2001.

3.2. Water Privatization in Argentina and the regulatory body: a bad example

The experience of Argentina supports the view that effective private participation is less likely to occur in water than in other public utilities. A country-wide privatization program was carried out, and in the city of Buenos Aires the privatization was done with the signing of a concession contract with Aguas Argentinas in 1992 before setting up a national regulation, or oversight body, as was the case with electricity. Privatization and regulation was decentralized so each local government, whether provincial or municipal, could pursue their own experience.

Why did Argentina rush so quickly into water privatization while other Latin-American countries did not? Buenos Aires, Mexico City and Lima all had the requisite capital flows needed to motivate a private concession (Shirley, 1998). Buenos Aires had the lowest proportion of connections in Latin American cities before the reform (70%), while Lima had similarly minimal connection rates (75%) and in fact were probably even lower if all of its poor neighbourhoods were included in the figures. As for Mexico City, the subsequent expansion depended upon substantial investment in water source development. The savings in maintenance costs would have been higher in Lima and Mexico City than in Buenos Aires. The numbers of people lacking access to water was high in the three cities, but although the numbers are not available, the cost of fresh water appeared to be higher in Lima and Mexico City (Shirley, 1998). In Buenos Aires the relatively clean water of the Rio de la Plata provides an extensive supply (although it is becoming more contaminated). Besides, since fresh water is more costly and scarce in Lima and Mexico City, other possible benefits of private participation could be the reduction of the consumption per capita due to meter installations, higher collection rates and price increases. For instance, the per capita consumption of 352 litres per day (LPD) in Mexico City is very high compared to the European rates of 100-150 LPD, although it is still lower than that of Buenos Aires, which

rises to 550 (table 3).

Table 3

Water System conditions in three Latin-American cities

	<i>Buenos Aires - 1992</i>	<i>México City - 1992</i>	<i>Lima - 1991</i>
Served population (in millions)	10	8.5	6.5
Population connected (%)	70%	97%	75%
Population without water access (%)	45%	33%	41%
Workers per 1,000 connections	3.4	14.4	4.7
Connections with meters	20%	NA	10%
Collection of invoices	80%	NA	43%
Water consumption (per capita LPD)	550	352	236
Average price per m3 in US\$ before reform	1993: \$0.33	1992: \$0.23	1993: \$0.21
Average price per m3 in US\$ after reform	1994: \$0.27	1993: \$0.30	1994: \$0.29

Source: adapted from Shirley (1998).

In Buenos Aires, water was free for many users before privatization, there were few meters; a third of all connections were unregistered, and many of those customers that were registered did not receive their bills or did not pay their bills when they received them. Around 68 per cent of total collections came from large industrial or commercial users that only represented approximately two per cent of the client base. It seems evident that adequate investment, meters, invoicing of all users, bill collection, and price setting do not necessarily require private participation.

Finally, it has been hypothesized that the decision to privatize is better understood in terms of the economic politics (World Bank, 1995). It has been argued that while the political benefits of private participation in water (income from sales and savings due to the withdrawal of subsidies for poor consumers) are normally low, the social welfare outcomes (better public health, conservation of water, and environmental improvements) can be quite high. Even more so it is suggested that the political costs (the private operator's need to charge higher tariffs to existing consumers, and the state officials' lost ability to channel income to political cronies) are often higher than the benefits. The crucial difference

in Buenos Aires was that the government could change the political benefit cost equation because the average water tariffs were high compared to the company's costs (the government increased water charges several times before privatization). The average price was considerably above its value before the reform took place. As a consequence, Buenos Aires would be able to offer its concession to the company with the bid with the lowest tariff and would be able to expect that the final price to the consumer would drop. The winning bidder in Buenos Aires offered a price that was 26.9 per cent lower than that charged by the state business. Although this was expected, the problems of information asymmetry implied that the contract had to be renegotiated later. This arrangement was further challenged by a weak regulatory body that was operating within an ill defined regulatory framework and without any mandatory governance mechanism, not even that which is required by law for all Argentinian public companies.

Regulatory framework and oversight body

Argentina granted the water service contract to the Aguas Argentinas consortium. This was formed by two major partners: Compagnie Generale des Eaux (then Vivendi and now Veolia) and Lyonnaise des Eaux (now Suez) who won based on their proposed rate reduction of 26.9 per cent, the largest of all the bidders. Within a year of signing the concession contract, Aguas Argentinas petitioned the newly-formed regulatory authority, ETOSS for a rate increase, even though the company had previously agreed not to impose any real rate increases for 10 years. ETOSS, whose operations are financed through a 2.6 per cent slice of the consortium's bill collection income, agreed, increasing rates by 13.5 per cent in exchange for expediting contractual investments.

The ETOSS regulatory body was established by decree 23.696 in February 1992. Although Aguas Argentinas only served the city of Buenos Aires, ETOSS's six members' directory represented three governmental actors: the national government, the provincial government and the municipal government. The Ministry of Economics and Public Works of Argentina appointed two members, the Ministry of Public Works of the

Province of Buenos Aires appointed two members, and the executive branch of the Municipality of the City of Buenos Aires appointed the last two. The only requirement for these six directors was that they should be public officials although having relevant experience was desirable. Although the directors were appointed by April 1st 1992, the body did not start operations until September 1992. The adjudication of the contract to Aguas Argentinas was signed on December 4th 1992 and operations started 4 months later in April 1993. ETOSS was designed to operate as an independent unit financed by the three government levels plus the 2.6 per cent slice of bill collection income. Directors' salaries were to be determined by the directors themselves in a collective manner.

A few months after ETOSS started functioning as an independent body, the president of Argentina undercut ETOSS' autonomy by signing a decree that placed it under the control of the Secretary of the Environment. The disempowered head of ETOSS appeared before Congress warning about the implications of this move, but this did not overturn the presidential decree. The dearth of the regulator's power and authority became evident to all when it was left out and ignored during the renegotiation of the contract in 1997, which occurred because the consortium had failed to make infrastructure investments as required by its contract. For instance, the company had only invested US\$9.4 million of a promised US\$48.9 million in sewage works and had built merely a third of the new pumping stations and underground mains that it had promised to complete by 1997. As a consequence of its lack of autonomy and power, ETOSS only started to apply sanctions to the privatized company in 2000 and 2001 when a new national government critical of privatization, which had been in opposition during the 1990s, came to power. The sanctions that were applied concerned elevated levels of nitrates (more than 45 mg/I) and low system pressure (less than 10 mca).

In October 2006 the ETOSS ceased to operate and was dissolved following the Argentinian government's cancellation of the concession to Aguas Argentinas enacted in National Decree 303 the previous March. A new regulatory body was subsequently created with the mandate to

monitor water quality.

Governance Mechanisms of Aguas Argentinas

The privatized company did not implement any of the corporate governance mechanisms recommended by the literature or by normal practice in Argentina. In Argentina it is typical for a public company to disclose the composition of its board of directors, organizational structure, remuneration of directors and managers, and internal control mechanisms such as the committee for the integrity of information (following the Sarbanes-Oxley act guidelines), the audit committee (which has been mandatory since 2001 for all public companies), and the administrative control committee (which is regulated in the commercial entities law and composed of certified accountants called '*sindicados*').

Aguas Argentinas has several partners, included among them is one of the largest local banks, Banco de Galicia, with a stake of more than 8 per cent. It is likely that such partnerships do have robust internal controls. Under normal circumstances, governance mechanisms would be in place to monitor Aguas Argentinas, but may not be publicly disclosed, due to their proprietary and commercially sensitive nature. The lack of transparency might be due to the firm's interest in keeping certain information private in order to increase bargaining power in re-negotiating contracts with the government. Clearly the lack of transparency backfired, causing a feeling of suspicion within the civil society, which in the end comprises the ultimate stakeholders.

Failure of water privatization

The water concession in Buenos Aires was not as effective as it could have been. One of its main failures, we argue, came about due to the absence of a truly independent and powerful regulator with budgetary autonomy. The auction of water services was rushed, with supporting regulations left undefined. As a result, investment goals and other contract obligations were subject to frequent renegotiations. In general, privatised service firms have pledged additional investments in return for charging higher rates. During the first years of the contract, weak

regulatory practices and contractual re-negotiations had the effect of substantially minimizing corporate risk and enabled the company to earn above average profits. For instance Suez reported an annual profit rate that averaged 19 per cent in the first 8 years of the contract (Azpiazu and Forcinito, 2002). However, when the governing party changed, Suez had to write off US\$500 million in losses in 2002. It is quite evident that the regulatory body, ETOSS, was subordinate to presidential power. During this period the privatisation process in Argentina was driven by one president, Mr. Menem, who allowed repeated contract modifications and non-compliance with performance objectives. Under subsequent presidents, all with a critical view of the privatization process, the ETOSS started to apply sanctions and finally recommended the termination of the contract and the reinstatement of a government owned company to run the water service.

The need to withdraw from water privatization in developing countries is a view also shared by transnational companies. In January 2003 Gerard Mestrallet, the chief executive of Suez, expressed concerns that water could not be delivered to the poor and that European standards cannot be applied in developing countries, therefore Suez planned to pull out of investments in poorer countries and to reduce its investment at least by one third in the immediate future (Robbins, 2003). The net result for 2003 and subsequent years was that Suez stopped expanding in developing countries and reduced its existing investments and activities. The company planned to sell unprofitable assets, while retaining those involving activities offering a better risk/return ratio and enhanced cash generation. Mr. Mestrallet also urged multilateral organizations such as IMF, World Bank and the Inter American Development Bank to develop appropriate intervention measures protecting international companies from currency and political risks, and also requested that development banks guarantee profits in US dollars (Robbins, 2003). Other big players in the water industry, Saur International and Vivendi (now Veolia) also expressed doubts about serving the poor in emerging and developing countries where the requirements of low risk and profitability mean that investments are

limited to big cities where the level of family income is not too low to guarantee a return (Hall, 2002). However, none of the big players in the water industry called for a set of governance mechanisms to be employed in emerging economies in order to increase the transparency of their operations as a way to gain trust and support from their stakeholders when pressured by the local governments. We see here a pervasive tendency to ignore corporate governance mechanisms, which cause serious difficulties for both privatized water companies and governments in emerging economies.

4. Conclusion

Water has significant externalities that require greater governmental intervention than other monopolies; information problems make private participation through contracts subject to more negotiation and also make them more difficult to control. To potential investors, this exacerbates potential regulatory risks. At the same time the political by-products of private participation are fewer than in other public utilities, while the costs are expected to be higher in the medium to long terms.

Buenos Aires is not the best case to imitate for a number of reasons, including the absence of a powerful and independent regulatory body and an ill defined regulatory framework and weak governance mechanisms. The challenge confronting future privatizations will revolve around several factors. First is that an efficient and independent regulator needs to be included in the process. Second, this regulator must represent all of the stakeholders' interests throughout despite the significant political pressures that will be brought to bear from both the private companies and the government. Third, a powerful and independent regulatory body as well as a complete set of corporate governance mechanisms are needed. Fourth, an excellent educational system able to train economists, accountants, lawyers and engineers among other specialists is needed that can design and implement efficient regulatory frameworks and governance mechanisms. Fifth, highly

qualified professionals working for regulatory agencies must be supported through payment of salaries that are generous enough to prevent them from being attracted by companies providing privatised services.

A good strategy for companies operating in ill defined regulatory environments and facing regulatory bodies that follow political commands from the government is to implement a complete set of governance mechanisms. The literature in governance mechanisms has many guidelines and most of the emerging economies have made local adaptations to the Sarbanes-Oxley act, allowing private companies managing public utilities to be very transparent in their operations. Although this strategy might reduce their bargaining power with the government when undergoing re-negotiations, at least they will not raise suspicions of mismanagement and appropriation of abnormal gains in the eyes of the public.

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