

**A PROPOSED POLICY FRAMEWORK
AND OPERATING STRATEGY FOR THE
PUBLIC PRIVATE PARTNERSHIPS IN
URBAN SERVICES PROGRAM (PSP)**

Prepared by

Jim McCullough
Fred Rosenswieg
Training Resources Group

The Urban Institute
2100 M Street, NW
Washington, DC 20037

UI Project 06610-001
June 1996

Prepared for

East European Regional Housing Sector Assistance Project
Project 180-0034
U.S. Agency for International Development, ENI/EEUD/UDH
Contract No. EPE-0034-C-00-5110-00, RFS No. 001

**A PROPOSED POLICY FRAMEWORK AND OPERATING STRATEGY
FOR THE PUBLIC PRIVATE PARTNERSHIPS IN
URBAN SERVICES PROGRAM (PSP)**

Improving the Efficiency and Effectiveness Of Municipal Enterprise Services

What this Component Covers

This component of the Local Government Partnership Program (LGPP) is focused on improving the performance of those key municipal services that are usually conducted by municipal enterprises. These services include:

- * Water supply and wastewater collection & treatment;
- * Solid waste collection and disposal;
- * District heating;
- * Transport and roads; and
- * Municipal housing maintenance.

These are the services that normally recover a large part of their costs from the consumers of the services in form of user fees. They also tend to require large amounts of capital investment and in Poland today, many of these services are still subsidized by the gminas.

These services are so important to both the economic well being of gminas and to the financial health of gmina budgets that the LGPP has made them an important focus of the program.

The objectives of the LGPP in this area are to help partner gminas to achieve:

- better quality of services delivered by municipal enterprises;
- increased efficiency in the use of resources (lower unit cost of services delivered);
- increased financial self sufficiency of municipal enterprises (higher percentage of total costs, both operating and capital, generated from user charges); and
- increased reliance on private sources of capital for investment in facilities rehabilitation and expansion (both equity and debt.)

What Types of Assistance are Available?

The Municipal Enterprises Component of the LGPP will work with individual gminas, regional

associations (unions) of gminas, individual municipal enterprises and, in some cases, private sector firms that contract with gminas and enterprises.

The assistance provided will be based on agreement between the LGPP and the partner gmina and will be clearly spelled out in a written memorandum of understanding. The specific plan of action will depend on the problem being addressed and will be tailored to that specific need. The memorandum of understanding will cover the plan of action, the timetable and the resources to be provided by both partners.

The LGPP assistance includes a wide array of technical consulting services and training. These services can range from broad advisory services to very detailed technical support. While the scope of these services is quite broad, we foresee that much of the support will be provided in the following areas.

Gmina Level

At the gmina level, assistance will be concentrated on helping local officials and council members select the right organizational forms of enterprises, improve oversight of enterprise operations (including tariff setting), negotiate concessions and contracts with the private sector, deal more effectively with the public (consumers, interest groups, unions) and improve the ability of the gmina to raise investment capital for needed infrastructure. This support will also be extended to regional associations of gminas which have a special set of problems dealing with cooperation across local government boundaries.

Enterprise Level

At the enterprise level, assistance will be concentrated on improving the internal management of the enterprise, financial management and cost recovery, innovative use of debt financing, service contracting and privatization options.

The Municipal Enterprise component of the LGPP will address the highest priority issues identified by the partner gminas and regional associations of gminas. While the LGPP will provide in-depth assistance on specific problems, we stress that the techniques and practices introduced by LGPP should also have a "spread effect" within the gmina - that is, the gmina should be able to transfer these approaches to other issues of municipal management within the gmina.

POLICY AND REGULATORY ISSUES

While most of the assistance provided by LGPP will be directed at the gmina and enterprise levels, there will be an additional component which will address issues at the national policy and regulatory level. For example, the national tax code and various laws dealing with enterprise forms have a great impact on the financial viability and operating procedures of municipal enterprises. This program will also provide information and technical support at that level to ensure that the national policy and regulations are conducive to effective functioning of municipal enterprises.

EXAMPLES OF LGPP MUNICIPAL ENTERPRISE ASSISTANCE

The Municipal Enterprise component will provide a wide range of support and cover an equally wide range of service types and situations. To give a clearer picture of the types of activities that might be undertaken, we present on the next 4 pages a series of Case Examples for the LGPP Municipal Enterprise component. In each "Case" below we briefly describe the problem faced by the gmina, or regional association, and the types of activity that might be undertaken with LGPP support to solve that problem.

CASE 1: MUNICIPAL TRANSPORT

PROBLEM:

The gmina provides poor transport service because the buses owned by its Municipal Transport Company (budgetary enterprise) are old and frequently out of service. However, the gmina and the enterprise do not have funds to purchase new buses.

ASSISTANCE:

The LGPP can provide expert consultants to help the gmina examine its different options for improving bus service. This would include options for :

- (a) issuing bonds to purchase buses for the Municipal Transport Company;
- (b) privatizing the MTC and selling shares to raise investment capital; and
- (c) several ways of allowing private bus companies to provide service on the routes through concession contracts.

The LGPP would assist the gmina and the MTC prepare the analyses which would show the impacts on bus services, financial condition of the gmina and MTC and tariff rates. The LGPP team could also assist in presenting the analysis to the gmina council if desired.

Once the gmina selected an option, the LGPP would help the gmina carry out that option. For example, the LGPP could help the gmina prepare the documents for the bond issue and serve as financial advisor in selecting the underwriters and negotiating the bond sale. Alternatively, if the gmina opted for the concession contracting, the LGPP could provide legal advice on preparing the contracts and could assist in preparing the contractual documents. Assistance could also be provided in analyzing the financial impact of differing terms and conditions during negotiations so that the resultant contract would be fair to both the gmina and the contractor.

At the completion of the assistance, the LGPP could provide assistance to the gmina in periodic monitoring of the project to make sure that the gmina was receiving full value.

CASE 2: REGIONAL LANDFILL

PROBLEM:

A group of small and medium sized gminas need to develop new sites for disposing of municipal solid waste and sludge from several wastewater treatment plants. The group has formed a regional association but they are having trouble agreeing on the type of company to create and operate the landfill and they have no ready funds to pay for construction.

ASSISTANCE:

The LGPP can first provide expert consultants to review the technical requirements of the landfill and make recommendations that would provide the best technical solutions at the lowest costs.

The LGPP can advise on the options for creating a regional company and provide models of incorporation and bylaws documents.

The LGPP can provide an analysis to the regional association showing the costs and benefits of differing approaches, particularly the tradeoffs among:

- (a) owning and operating the landfill by the association;
- (b) owning the landfill and contracting out management;
- (c) contracting with a privately owned landfill.

Depending on the model selected, the LGPP can provide technical assistance on setting prices that recover operating and capital costs.

The LGPP can provide assistance in negotiating long term management contracts, or if the privatization option is selected, the long term service agreement.

If the association decides to build the landfill itself, the LGPP can provide financial advisory assistance in developing the financing plan and in putting together a package of grants and loans for the capital construction. This might also include assistance in a bond issue, as noted under Case No. 1.

CASE 3: PUBLIC INVOLVEMENT

PROBLEM:

The gmina water and sewer company has a proposal to raise tariffs by 50% to pay for debt service on a new wastewater treatment plant. It is also proposing to reduce its workforce by one third by contracting out the operation and maintenance of its water distribution system and vehicle maintenance. Anger by the workers and the consumers is blocking both actions in the town council.

ASSISTANCE:

The LGPP can provide several types of assistance to help the gmina avoid such situations and to help it solve this particular problem.

First, the LGPP can help the enterprise develop employment policies that smooth the transition to more contracted labor (e.g., provisions that require contractors to hire a certain percentage of the redundant workers). This can be done cooperatively with the workers and unions. Second, the LGPP can help the enterprise develop mechanisms for involving consumer groups in long range planning so the impacts of those plans (e.g., tariff increases) have the advance consent of the rate payers. The consumer groups and unions can also be informed of the financial performance of the enterprise so they are aware of the need for tariff increases (or staff cost reductions) and steps that the enterprise is taking to control costs.

The LGPP can help the enterprise staff develop a public relations program including training of staff and in presenting information to the gmina board and council so that the information is persuasive. The LGPP can also provide analyses and train the enterprise and gmina staff in conducting such analyses to demonstrate the tradeoffs that will have to be made between tariffs, investments, operating costs and personnel.

CASE 4: DISTRICT HEATING

PROBLEM:

The gmina heating enterprise continues to request increasing amounts of subsidy from the gmina council which takes a large percentage of the gmina budget. The council members do not have enough information on the financial condition of the heating enterprise or its service characteristics to know whether the subsidy is justified. The current managers of the enterprise have also made a proposal to privatize the management of the enterprise and enter into a service contract with the city. The council members are divided on the merits of the proposal and have no hard data to use in making the evaluation.

ASSISTANCE:

The LGPP can provide consultants to the gmina to establish a system of performance measures which the council and board can use to monitor the financial and technical performance of the heating enterprise. This can be used by the board to determine the efficiency of the management and to track costs over time. The LGPP can assist the council and board in preparing a financial plan for the heating enterprise that sets performance standards for service delivery, establishes financial cost controls and links subsidies to meeting these targets.

The LGPP can also provide comparative information from other cities so the gmina council can see how its heating company compares to others, in terms of cost and service performance.

The LGPP can provide assistance to the gmina council in establishing performance targets for the management of the heating enterprise whether or not it is privatized. If the council decided to enter into a management contract, the LGPP can help the council evaluate the proposal and put performance criteria into the contract. The LGPP can also provide legal advice on drafting the contract and provide examples of model contracts.

The LGPP can also provide assistance to the enterprise management in ways to improve performance through internal audits.

Annex 1

MUNICIPAL ENTERPRISES ANALYSIS OF THE CURRENT SITUATION

Introduction

As part of its Local Government Partnership Program, the U.S. Agency for International Development is designing a component to improve the efficiency of municipal enterprises. Municipal enterprises include such services as water and sewer, solid waste, transport, and heating. In May 1996 a team of U.S. and Polish consultants carried out an initial assessment of the current situation and identified possible ways in which USAID might provide assistance. The team interviewed a range of organizations working in areas related to municipal enterprises. These included the Municipal Development Agency (MDA), Ministries of Privatization and Planning and Construction, associations representing the enterprises of district heating and water/sewer services, donors working in the area of municipal development, other USAID contractors, and Polish private sector organizations. The team also visited eight gminas to meet with mayors, members of the executive board, and enterprise managers.

The municipal enterprise component will focus on five sectors: water and sewer, solid waste, heating, transport, and housing management. These are the services which are most frequently organized on an enterprise basis at the gmina level and which most amenable to being operated as enterprises.

The purpose of this short paper is to summarize the results of the assessment and the issues and problems which were identified.

The team identified needs that fall into four main categories, each representing a different target audience. These categories include:

- o policy and regulatory issues
- o gmina level issues
- o enterprise level issues
- o private sector issues

The priority issues in each of these categories is discussed below.

Policy and Regulatory Issues

Income Tax on "Profits"

The most important policy issue is the current law which requires that all municipal enterprises pay an income tax of 40% on all profits. Profits are defined as all revenues that exceed operating costs. Commercial code companies are required to include depreciation as part of their operating costs while budgetary companies have the choice whether to include it. Neither commercial code companies nor budgetary companies are allowed to count investment as an operating cost. The net result is that revenues that are available for capital investment are effectively reduced by 40%.

This policy is often the main determining factor in how municipalities organize their municipal enterprises. Since gminas want to avoid paying taxes, they often pair winners and losers in the same enterprises. In some cases

they have created a “holding company” for all the enterprises so they can pass costs back and forth. These types of arrangements mean that profitable enterprises are in effect subsidizing unprofitable ones and masking the true costs of providing services. The mayor and enterprise managers in one of the cities visited said that if the law were changed, they would immediately create two commercial code companies, one for water and sewer and the other for heating since both were profitable companies.

Another consequence of this policy is that it creates a disincentive to be profitable. One mayor stated that the enterprises run their business so they will not make a profit. They will lease instead of purchasing even when they know in the long run, purchasing would be cost effective.

The central government can deal with the taxation issues by 2 means - reform of the tax codes and/or creation of tax exempt status for municipal enterprises, a mechanism used extensively in the USA. A Parliamentary committee is drafting new legislation on Municipal Enterprises that considers the issue of tax exemption. However, there is considerable opposition to either tax reform or creation of non-profit authorities, so action on this key issue has been held up for some time.

Solid Waste

Currently, municipalities cannot compel anyone to have garbage collected by a particular entity. Gminas routinely include solid waste collection as part of the rent for those who live in public housing, but this does not apply to private dwellings. Private dwellers either hire unregulated small solid waste contractors to pick up their garbage or dispose of it themselves. In most cases these unregulated contractors dispose of the garbage illegally to avoid tipping charges at the landfill, thus reducing their costs substantially. Individuals also dispose of their garbage in illegal sites.

There are several consequences from the lack of the solid waste law. First, the gmina finds it difficult to create a financially viable enterprise since a sizeable part of the potential market is lost to a less expensive contractor. Second, because a significant percentage of the solid waste is not disposed of properly, there are environmental consequences. A solid waste law is now being drafted which would allow municipalities to compel its citizens to have their garbage picked up by a company of the gmina's choosing.

Gmina Level Issues

Selection of the Right Type of Enterprise Model

Small and medium size gminas have a limited understanding of how to select the most appropriate type of enterprise model: a budgetary organization, a limited liability company owned by the gmina, a management contract with a private sector firm, or a fully privatized operation. In addition, as noted above, the new Municipal Enterprise Law being drafted may create a new form of local public authority which will be available to gminas. In general, gminas are not familiar with the advantages and disadvantages of each model and how to decide which model is most appropriate. They do not know what information they need to make a decision and how that information should be analyzed. For the most part, the type of enterprise model selected by the gmina is determined by the desire to avoid the corporate income tax, keep tariffs low, and not lose control by contracting with a private firm.

Model Contracts

One of the impediments to using management contracts is the lack of knowledge of what goes into such a contract. One mayor visited said that he was aware that there were specific performance standards for each type of

service, but that he did not know what they were even though the city had recently awarded a contract with a private firm for maintenance of green areas. The mayor was well aware that the lessons from that experience were not necessarily transferable to another service. In addition to performance standards, contracts must address such issues such as guarantees, liability, the length of the contract, incentives, etc. Providing model contracts in each sector would be of great value in encouraging greater use of the private sector.

Performance Monitoring

One of the questions asked each gmina was how they monitor the performance of the enterprises. The answer was invariably that the gmina monitored the revenues and expenditures, mostly against the annual budget. The other common response was that the absence of complaints meant that the customers were happy with the services provided by the enterprises. Only the water and sewer enterprise in Krakow had a different answer. The general manager said they had developed a series of performance indicators to monitor the quality of the performance of the enterprise. He cited unaccounted-for-water and water quality as two indicators they use.

This indicates that there is a lack of understanding on how to measure the quality of services. USAID could be of great assistance in defining performance measures for each of the five target sectors. These indicators could be used in developing model contracts for private sector concessions as well as for monitoring the performance of municipally-owned enterprises.

Working with the Councils

One of the major impediments to improving municipal services is a reluctance to raise tariffs. Understandably the town councils want to keep tariffs as low as possible. In our meetings with mayors, we found examples of mayors and enterprises wanting a tariff increase to pay for needed improvements, but a reluctant council. One of the areas of assistance this program can provide is to improve the understanding of mayors and gmina councils of the financial relationships between gminas and enterprises especially the complex relations linking tariffs, subsidies, and debt management. If the gmina leadership has a more complete understanding of these financial relationships they will be better able to adopt sound tariff policies and investment programs. Otherwise they will continue to subsidize enterprise operations from the gmina budget while other investment needs go unmet.

Enterprise Level Issues

Management Practices

With the exception of some of the larger cities, enterprises are not using modern management practices. Management practices includes a wide range of skills. They include the day-to-day management skills such as delegating work, performance monitoring and feedback, resolving conflicts, running a meeting, motivating staff, and teamwork. They include financial management skills such as budgeting, accounting, and cost management. They also include such concepts as running the enterprise like a business and having a customer service orientation. Management practices are one of the keys to running an efficient operation, keeping costs under control, and implementing improvements in daily operations.

Public Involvement

Discussions with mayors indicated that some gminas have an understanding of how to implement a public education program. They cited the use of such mechanisms as community meetings, articles in the local press,

programs on local television, and written information. However, the use of these communications channels were generally to convince the public of a decision already taken. Only in the case of Krakow did the enterprises demonstrate a broader understanding of public involvement. The water and sewer enterprise has established a public relations unit which is staffed by specialists. They produce brochures, run public meetings, and organize field visits on a regular basis. The general manager said they when the enterprise realized that everything they do is ultimately dependent on its customers and their willingness to pay, they decided to institute a regular program. In a similar vein, the solid waste enterprise focuses its regular educational programs on young people.

In addition to keeping the public informed, an outreach program should also involve citizens in making major decisions. Is a community willing to pay a higher tariff for an improved wastewater treatment plant? Is the community willing to pay higher bus fares for more frequent and reliable service? Enterprises need to develop the skills to seek out the opinions of the public before unilaterally making such a decision and then working to convince the public of its merit. The skills to find out what people think include running focus groups, running effective community meetings, and conducting surveys.

Investment Capital and Debt Management

Enterprises have a limited understanding of the different options for raising investment capital and managing debt. In nearly every gmina visited, enterprise managers and mayors had plans for investment although there has been relatively little use of debt among enterprises except in the case of water and sewer companies. However, even for companies that have already taken on debt, few have actually reached the point of full scale debt repayment

Enterprise managers generally do not know how to choose between different debt options and the effect that different technologies have on the amount of capital they need. This area clearly touches on broader issues of the gmina's fiscal policy and the ability of the gmina to carry debt. It also involves the structuring of individual investment projects and the sharing of responsibility between the gmina and the enterprise for repayment and guarantees against risk. This, of course, affects the debt capacity limitations of the gmina and the overall fiscal policy of the gmina.

A special case in this area is created by the regional associations since the gmina-enterprise relationship is made more complicated by the involvement of several different gminas. New types of loan covenants and guarantee mechanisms need to be developed to deal with this issue - quite apart from the complex governance issues involved. This is one of the reasons that such associations have been slow to form and to operate effectively.

Creating Market Conditions

Lack of Information

Although the consultant team did not have the time to do a full survey of the capability of the private sector to provide services, the team does have some preliminary observations. There seems to be a lack of information on the needs of municipal enterprises and the market potential for private sector firms. Preparing a market analysis publication and disseminating it through private sector channels may generate increased interest by private sector firms. It may also be possible to organize a conference on private sector opportunities in municipal services. Although the initiative for creating an attractive market for the private sector must come primarily from the gminas, some effort to stimulate interest by the private sector may help.

Perceived Risks

One of the key barriers to increased private sector involvement is the perceived risks. While there appears

to be a considerable amount of small scale private sector contracting with gminas, there is little large scale investment such as major "build-operate-transfer" (BOT) projects in the sector. While there has been considerable exploration by foreign private sector firms, actual execution of projects is quite limited. There is one major joint venture in water/sewer operations in Gdansk and some preliminary investigations for several BOT landfill projects. There are foreign joint ventures operating bus companies in 3 cities but reportedly other private transport firms have trouble obtaining credit financing for rolling stock. The World Bank has developed a guarantee mechanism that will help insure against risk of payment default by cities to private sector concessionaires, especially for projects like landfills and wastewater treatment plants where cities must enter into longterm "take-or-pay" contracts to make the project financially feasible.

There are no structural barriers to private sector participation in these services. However, the market is not yet developed and there is a lack of general information and proven prototypes to follow. This calls for mainly an information dissemination strategy.