



Water Integrity Brief

Providing a concise overview of specific themes related to water integrity

Regulation

Regulation: Catalyst for Better Governance and Enhanced Integrity in Water Utilities?

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BACKGROUND

Most urban water supply and sewerage services are provided by public entities – usually public utilities – which are subject to varying forms of control and regulation. However, poor governance and especially corruption compromise the performance of many water utilities, especially in the developing countries, resulting in low coverage and poor-quality services. In many countries, regulatory authorities or units have been created in order to increase the efficiency and quality of services, and to promote transparency, accountability and participation in water service provision. In situations where unethical behaviour and malpractices in utility management are persistent challenges, regulators may also become catalysts for increased integrity in water utilities. In order to deepen the anti-corruption agenda in regulation, incentive-based tools such as corporate governance guidelines and benchmarking are recommended. These should be combined with a cooperative approach, in which regulators involve consumers, build partnerships with public oversight institutions, and support utilities in building an integrity infrastructure. As regulators themselves face risks such as capture by stakeholders or extortion of service providers, transparency in the regulatory process also needs to be safeguarded. This paper focuses on economic regulation.

GOOD WATER UTILITY GOVERNANCE – A KEY CHALLENGE

As the human right to safe drinking water and sanitation became widely recognised, the obligation of governments to work towards universal access to water services began to receive new attention. Globally, approximately 90 per cent of (urban) water services are delivered by public water utilities (IWA 2012). These



Regulation can provide incentives for utilities to extend water and sanitation services to unserved consumers © Water Services Trust Fund, Kenya

entities play a key role in the progressive delivery of the right to water and sanitation, as part of their obligation to provide the required services and contribute to the better living conditions associated with affordable and safe drinking water and adequate sanitation (PSIRU 2006).

However, many of the public water utilities and publicly-owned service providers in the developing world fail to provide adequate water and sanitation to consumers, with poor segments of societies suffering particularly from deficient services. Poor governance at utility- and sector-level is a root cause of inefficiency and corruption in day-to-day operations and decision-making in water utilities. While some challenges related to performance and efficiency in service provision may certainly be attributed to a lack of investment, management systems and technical skills, it is evident that good governance is a key factor for better utility management (IWA Publishing 2011, Auriol/Blanc 2009). Good utility governance cannot emerge or exist in a vacuum. It requires a sound legal and institutional framework, and can be further promoted by an enabling regulatory framework (Corporate Governance Forum 2009).

Governance and corruption hot-spots in water utilities

Utility governance (see Figure 1) refers firstly to internal rights to control, information and decision-making within the organisation, including structures and values guiding the interactions between actors such as directors, managers and staff members. Utility governance also has an external dimension, comprising sector policies, the legal-institutional framework and the provider's relationships with external stakeholders such as the asset holder (frequently the municipality or government), the board, suppliers, the regulator and different consumer groups (IWA 2012).

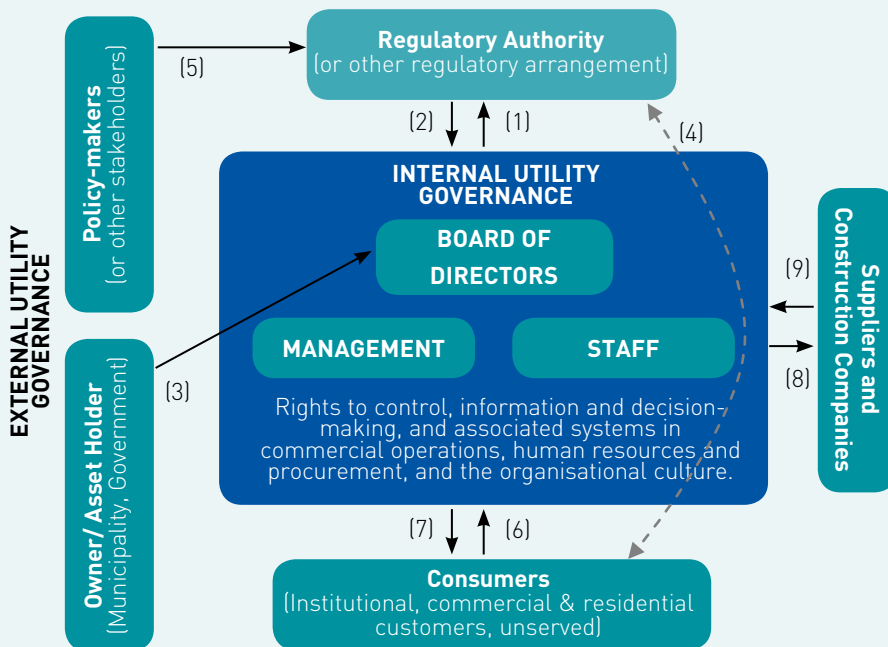
Interactions between stakeholders (e.g. between utility employees and customers, board members and the utility, suppliers and project owners) are guided by formal contracts or agreements defining obligations, rights and responsibilities or standards of behaviour for the different actors. The core problem of utility governance is that these contracts or agreements are often violated or incomplete. They provide leeway for opportunistic behaviour, i.e. actors may maximise their individual benefit at the expense of the utility and the public.

Although transparent and accountable governance arrangements and practices are favourable to utility performance, poor governance practices prevail in

many situations. This frequently results in a failure of utility management, i.e. activities and processes related to the planning, organising, staffing and leading of the utility in order to produce goods and deliver services efficiently. Management systems may also provide loopholes for the misappropriation of resources or manipulation of information, opportunities for the 'abuse of entrusted power for private gain' (WIN/TI 2008).

Many examples of petty and grand corruption¹ in utilities exist. For example, in the case of a Kenyan water utility, the manipulation of the accounting system led to the misappropriation of approximately €250,000 from utility bank accounts. In other cases, directors convene up to 20 board meetings per year in order to pocket allowances; the resulting excessive expenditure drains resources from the utilities (GIZ 2012a). At Cambodia's Phnom Penh Water Supply Authority, the reform-minded General Director was threatened when he tried to make all customers pay for their water consumption: 'One army officer refused and even pointed a pistol at him' (IUCN 2010). Corruption as documented in these cases puts the commercial and technical efficiency of utilities at risk and may jeopardise the public reputation of utilities, as well as consumer willingness to pay for services. Generally, corruption in water utilities occurs in five 'hot-spots' – interlinked high-risk areas (see Table 1).

FIGURE 1



See table 1 for explanations of the relationships.

Factors driving successful utility governance

Water supply and sanitation are basic services. Accordingly, the way water utilities perform their business requires governance arrangements and practices guided by the principles of transparency, accountability, participation and integrity. They must be reflected in the overall governance framework in which a utility operates, as well as in the set-up of management systems such as up-to-date billing systems, transparent accounting and professional human resources management. While compliance with formal rules and systems is important, these principles must also be part of the corporate culture guided by values such as professionalism, probity and honesty. A culture of integrity can provide incentives and stimulate intrinsic motivation for directors and managers to align their

¹ Petty corruption refers to abuse of entrusted power by low- and mid-level public officials in their regular interactions with citizens accessing basic goods or services provided by public institutions. In contrast, grand corruption refers to acts „committed at a high level of government that distort policies or the central functioning of the state, enabling leaders to benefit at the expense of the public good“. (TI 2009)

TABLE 1 Corruption risk areas in service delivery and regulation

	Risk Area/ Process	Actor/Stakeholder	Type of Corruption
A) Oversight and Regulation			
(1)	Performance agreement, compliance monitoring and benchmarking (inter alia)	Staff of regulator	Extortion of utility
(2)	Reporting on performance and governance indicators	Utility staff	Bribery of inspectors; submission of manipulated data to regulator
(3)	Oversight/ supervision	Utility board of directors	Nepotism in nomination processes; capture; abuse of office for undue interference in management decisions (tariffs, staffing, etc.)
(4)	Consumer feedback and complaints	Consumer representative bodies/ groups	Misuse of funding or mandate at cost of regulator
(5)	Oversight/supervision	Regulator's board of directors	Capture by political decision-makers; undue interference in regulatory decisions (tariffs, etc.)
B) Commercial Operations			
(6)	Service delivery and customer care	Utility staff and consumers	Collusion in billing, meter reading
(7)	Payment, complaints and feedback	Utility staff and consumers	Bribes
C) Procurement and Tendering			
(8)	Delivery of goods and services (e.g. construction)	Utility staff, auditor and contractor	Collusion in construction supervision (e.g. manipulated certificates)
(9)	Supervision, bidding/selection of contractor	Utility staff, bidders	Kick-backs and collusion
D) Human Resources Management (internal)			
(10)	Recruitment decisions, promotion	Utility staff and managers	Patronage and discretion; fraud (ghost workers, job-selling, etc.)
E) Company Property and Stores (internal)			
(11)	Stores management	Utility staff and managers	Misuse of company property (e.g. private use of utility vehicles); theft of hardware or funds

Based on World Bank 2008

decisions and actions to the utility's performance objectives. This in turn may also promote responsible and accountable behaviour among the utility staff in their day-to-day operations and interaction with stakeholders. It reduces the leeway for opportunistic or corrupt behaviour.

The experiences of the Office National de l'Eau et de l'Assainissement (ONEA) in Burkina Faso and the Phnom Penh Water Supply Authority (PPWSA) presented in box 1 below suggest a number of key factors for successful governance and management reforms. These include a functioning regulatory arrangement (such as the performance contract of ONEA) and a conducive institutional framework (as in both cases) catering for managerial autonomy and ring-fencing of revenues. Such measures help prevent undue interference in utility operations and generate incentives for better performance. Experience shows that the integrity of decision-makers and committed leadership are of paramount importance for successful

utility reform and to ensure the trickle-down of values such as probity and professionalism to staff.

REGULATION AS A CATALYST FOR BETTER UTILITY GOVERNANCE

Improvements in sector and utility governance may be promoted and, more importantly, sustained through conducive regulatory systems. While regulation was often introduced during the past two decades in the wake of private sector participation, the potential merit of public utility regulation is increasingly being recognised (IWA 2012).

The overall objective of economic regulation of water services is to ensure that the natural monopoly of water service providers is not abused and that the services are delivered in an efficient, fair and sustainable way (Trémolet/Halpern 2006). The design of a regulatory systems is very country-specific. In

BOX 1: EXAMPLES OF GOOD UTILITY GOVERNANCE AND MANAGEMENT REFORM

Office National de l'Eau et de l'Assainissement

The national water provider in Burkina Faso, Office National de l'Eau et de l'Assainissement (ONEA), is a striking example of how reform of the governance framework based on accountability and transparency can lead to considerable improvements in performance. Through the transformation of ONEA from a quasi-public agency with little autonomy into a limited liability company corporatisation, non-revenue water (i.e. water losses) was brought down to 17 per cent, services were improved and coverage increased. At the same time, commercial viability was secured with a collection ratio efficiency, i.e. the share of revenues collected of the total amount billed, of more than 95 per cent and fewer than five staff per 1000 connections (figures from 2008). Now ONEA is widely perceived as one of the most successful public utilities in Sub-Saharan Africa. Key to the success was that the government refrained from interference. Guided by independently monitored three-year performance contracts, the management makes day-to-day operational decisions autonomously. ONEA also modernised its business procedures and billing system, and introduced an internal control system to fight corruption (PPIAF 2010).

Phnom Penh Water Supply Authority

Phnom Penh Water Supply Authority (PPWSA) serves around 1.3 million people in Cambodia's capital. Before 1993 it was plagued by the same challenges as many other Asian water utilities. 'Inefficiency' – a result of malpractices and weak control and management systems – resulted in high non-revenue water, financial losses, illegal connections, a lack of appropriate billing and poor network maintenance. However, over a period of 15 years, PPWSA underwent major reforms, which transformed the utility into a successful water service provider. Coverage increased to 90 per cent of the service area, non-revenue water was reduced to less than 10 per cent, and collection efficiency stands now at almost 100 per cent. This noticeable performance improvement was achieved through an enabling external framework, including a legal framework ensuring autonomous management based on commercial principles, and the ring-fencing of revenues from water services. This provided strong incentive for the utility to be innovative and perform better. The external framework was complemented by comprehensive internal reforms, such as departmental planning and reporting that ensured direct accountability; regular publishing of reports on performance indicators reviewed by PPWSA's administrative council, and independent auditing. Complaint registration kiosks and information campaigns increased accountability to customers (IUCN 2010).

many countries such as Burkina Faso, or in Uganda (where the National Water and Sewerage Cooperation operates under a performance contract with the national government), contracts between governments and utilities which set performance targets for a multi-year period are common practice ('regulation by contract'). In other countries, regulatory units are created in the water administration, or competition authorities perform regulatory functions in combination with 'public control' mechanisms – as in Germany. In about 57 countries worldwide, autonomous water services regulatory authorities or regulatory units in ministries have been established at national or regional levels (IWA 2012). These can be found mainly across the Anglophone world – in particular in Southern and East Africa, but also in Asian or Latin American countries, such as Colombia and Brazil.

Regulatory authorities² (regulators) ensure that water utilities comply with existing rules, through a set of instruments including tariff-setting procedures, licensing of utilities, public performance reporting, service standards (e.g. for water quality) and other guidelines. Traditionally, water services regulation focused more on allocative and productive efficiency in service provision and consumer protection. More recently, however, it has been acknowledged that regulation must also address socio-distributional concerns, particularly in developing countries (pro-poor regulation), and that absent or inadequate regulation may contribute to poor governance and management of water utilities (Pollem 2009, Franceys/Gerlach 2008).

Fostering integrity in water utilities

Regulation has a two-fold objective:

1. It seeks to prevent undesirable behaviour in the regulated entities. A regulator deters non-compliance with its rules and guidelines through sanctioning mechanisms, and provides incentives for improved behaviour and better management (the 'control approach'). This mandate must be supported by a capacity to monitor compliance effectively, including the right to verify performance data, e.g. through on-site inspections, data cross-checks of reported information or direct feedback from consumers.
2. A regulator may also create an enabling environment through collaborating with a utility to reach higher performance levels (the 'cooperative approach') (IWA Publishing 2011).

Regulators are advised to apply a combination of control and cooperative approaches in promoting better utility governance.

² Regulatory authorities may differ in terms of the regulated industries (single- vs. multi-sector regulators) or the degree of financial, political and administrative autonomy (ranging from independent entities with final decision-making authority, to autonomous entities located in an existing line ministry, or advisory non-ministerial regulators) (World Bank 2006).

The monitoring of utilities' compliance with service standards and benchmarking of their financial, technical and commercial performances by regulatory authorities are seen as important drivers for efficiency and increased accountability. While the setting and monitoring of minimum standards (e.g. for service quality) and guidelines (e.g. for board conduct) remains a core function, the regulator may complement this by a cooperative approach fostering aspirational values, integrity systems and better management practices.

“Regulation can serve both as a control limiting undesirable behaviour, and as a facilitator creating an enabling environment for conduct based on integrity.”

The Kenyan Water Services Regulatory Board (WASREB) provides an example of combining control-based approaches with cooperative elements. In recent years, this regulator has contributed significantly to increased transparency, social accountability and participation in the delivery of water services in Kenya.

The regulatory instruments applied by WASREB help optimise the internal management systems and improve the corporate culture of utilities. The obligation to report technical, financial and commercial data to the regulator and to the public sets an incentive for utilities to establish and refine their management information systems, which in turn closes loopholes for corruption and fills information gaps. Standards on complaint handling procedures and consumer support groups foster a notion of accountability towards customers among utility managers and staff. This was evidenced in the towns of Mombasa, Kisumu, Kakamega and Nairobi, where 90 per cent of longstanding customer complaints were resolved through mediation by local Water Action Groups³ (WASREB 2011). The regulatory systems of many other countries, including England and Wales, Ghana, Zambia, Tanzania and Bolivia, also cater for end-user feedback on service quality through direct consumer involvement or representation (Cranfield University 2005, OFWAT 2011).

Water services regulation is not introduced per se to combat corruption. Even though many corruption risks may be mitigated through effective regulation, the informal rules and unethical practices that reinforce corruption in water utilities and their interactions with stakeholders are very persistent. Water services regulators in a number of countries have therefore started to develop and implement specific tools in an active effort to prevent corruption. For example, the Zambian National Water and Sanitation Council (NWASCO) recently convened a Water Sector Financial Forum, attended by representatives of water utilities and the national Anti-Corruption Commission. As a result of the Commission's call for more ethical conduct and accountability in water services and the forum's recommendations, NWASCO has started to formulate sector guidelines which will see the formation of integrity committees in all water utility



Unregulated, informal sanitation service providers do not comply with human right standards, Mathare, Nairobi, Kenya © Daniel Nordmann

companies to counter corrupt practices'. In Kenya, the Water Integrity Network and the German Development Cooperation (Deutsche Gesellschaft für Internationale Zusammenarbeit, GIZ) are currently supporting the development of integrity management systems for water service providers, which will be embedded in the existing regulatory framework.

Transparency in the regulatory process

It is a demanding task to balance the diverse interests of consumers, service providers and political decision-makers. A regulator is as prone to abuse its monopoly power as the organisations it regulates. It may try to 'sell' its regulatory decisions for bribes, or inspectors verifying performance data or compliance with guidelines may attempt to extort the regulated utilities (Boehm 2009). A regulator must be honest and operate in a transparent and accountable manner to ensure its credibility (WIN/TI 2008).

To make a regulatory system effective and legitimate, the regulator itself must be safeguarded against corruption, capture and undue interference from stakeholders. For example, political decision-makers may have an interest in influencing tariff decisions to keep prices low. In order to ensure decision-making is depoliticised, a regulator must have autonomy guaranteed through provisions such as a strong legal mandate, clear separation of regulatory and policy functions, and a source of revenue independent from political considerations (e.g. a regulatory levy from utilities). The establishment of the a regulator should also provide for autonomy with regard to managerial decisions (e.g. in human resources), competitive recruitment, adequate salaries for staff and a lean structure.

Accountability mechanisms for a regulator include appeal rights for stakeholders believing that their interests were harmed by regulatory decisions, an obligation to report to the public and state institutions on its performance (e.g. board expenditures) and decisions, regular audits and performance reviews, oversight and control (e.g. through a multi-stakeholder

³ See also WIN Case Information Sheet No. 4/2012 on Water Action Groups.



WAG members in a discussion with engineers from Nairobi City Water and Sewerage Company © Water Services Regulatory Board, Kenya

board). These measures should be complemented by extensive transparency measures regarding the decisions, rules and procedures applied by the regulator. For example, information on licences, tools, proceedings and the reasons for regulatory decisions must be made available to the public (World Bank 2006). To safeguard staff integrity and prevent conflicts of interest, the authority should adopt a code of conduct and establish formal processes for its implementation, as carried out recently by the Albanian Water Regulatory Authority (GIZ 2012b; Boehm 2009).

Strong regulatory oversight requires mechanisms that strengthen the mandate and independence of the regulator and establish internal structures and incentives that ensure staff integrity and accountability.

RECOMMENDATIONS

Corruption and poor governance practices are a key impediment to better water and sanitation services and to the delivery of the human right to safe drinking water and sanitation. Although regulation of water services is not introduced per se to combat corruption, it can play an important role in improving sector and utility governance in a sustainable manner. Regulators may gradually deepen their integrity agenda by applying a combination of the two approaches to regulation – control and cooperation. In setting up and further developing regulatory frameworks that actively foster integrity, the following recommendations should be considered:

- To be legitimate and effective, regulators require autonomy and provisions safeguarding transparency, accountability and integrity in regulatory decision-making.
- Regulators should monitor, benchmark and report to the public on traceable corporate governance indicators (e.g. on board expenditures and composition) and disclose information on members and decisions, to encourage ethical practices and incentivise poor performers.

- Regulators should apply effective sanctioning mechanisms in cases of repeated non-compliance with standards or guidelines on corporate governance (e.g. on board nomination procedures, disclosure of information). Excellent performance by a utility in terms of governance indicators should be rewarded, e.g. through integrity awards, representing public acknowledgement of efforts by utilities (or individuals) with regard to integrity management.
- Regulators should develop minimum standards for the design of water utilities' integrity management systems. Such systems serve to prevent corruption and operationalise integrity values through risk and quality management approaches, including anti-corruption policies, codes of ethics and disclosure, ombudsmen, corruption reporting channels or corruption prevention training.
- Regulatory authorities should collaborate with other regulatory and public oversight institutions, such as anti-corruption commissions, parliament, public procurement authorities and auditors, tapping into their capacity and mandate to prevent, detect and prosecute corruption.
- Regulators should strengthen the role of consumer feedback and use quality media reports as a source of information to assess service quality and utility governance.

While the prosecution of corruption is clearly not the mandate of a regulator, but of the judiciary and dedicated anti-corruption authorities, a regulator may nevertheless play a role in mitigating corruption risks on the administrative level and detecting high-risk areas in service provision. Such an agenda may also be informed by diagnostic studies that map out existing corruption hot-spots in the sector. Regulators may set incentives and actively support organisational and behavioural change processes geared towards integrity, i.e. a corporate culture and individual behaviour based on values such as probity, professionalism and honesty. As evidenced by an increasing number of authorities, regulators can move beyond their traditional role as efficiency drivers, to become catalysts for better governance and enhanced integrity in water utilities.

For a detailed list of references that this paper is based on, please contact us or refer to WIN's website.