

Public Private Partnerships
and the Poor

Private Sector Participation and the Poor

2 - Implementation

Series Editor: M. Sohail

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Halcrow Management Sciences



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Private Sector Participation and the Poor:
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About this series

The purpose of the project *Public Private Partnerships and the Poor in Water and Sanitation* is to determine workable processes whereby the needs of the poor are promoted in strategies which encourage public-private partnerships (PPP) in the provision of water supply and sanitation services. One of the key objectives is to fill some of the gaps which exist in evidence-based reporting of the facts and issues around the impacts of PPP on poor consumers. This series of reports present the interim findings and case studies of an analysis of both the pre-contract and operational phases of a number of PPP contracts. A broad view of PPPs has been taken and situations where the public sector is in partnership either with formal private sector companies, or with small scale local entrepreneurs, or with NGOs employed in a private sector capacity have been included.

M. Sohail
Series Editor

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1.

Report overview

1.1 Statement

This report has examined a number of projects and drawn upon the experience of key players associated with PSP in the water sector. We have identified some recurring themes in relation to provision of services to the poor. We do not attribute findings to any specific project and highlight the shortcomings not as criticisms, but in the interests of sharing of knowledge and improving services to the poor in the long run.

1.2 Overview

In this report we assess the effects on the poor of PSP in the water and sanitation sector. We examine the key stages in the procurement process, detail the approach typically used by professional advisers involved in managing the transaction, and identify some unintended consequences which appear to impact upon services to poorer communities. We discuss the advisers' ability to accommodate pro-poor issues in their work and we highlight the compounding effect of tight timescales, unreliable information, legal constraints and political sensitivity which can seriously limit the reach of the PSP arrangements in relation to supplying the poor.

We reason that the greatest opportunity for accommodating pro-poor issues is at the planning stage and that process constraints, essentially competitively selected and contract-orientated advisers and operators, can restrict the resulting inputs and outputs of the key players. This in turn can limit their ability to properly address issues relevant to the poor.

We have examined several projects and noted some recurring themes including insufficient understanding, research, planning and priority being given to pro-poor issues. These can result in deficient outline contract specifications which become progressively more concrete as the process develops. When this is coupled with highly competitive (and occasionally opaque) procurement, in which hard-nosed competitors vie for lucrative long-term contracts, the result can be a questionable commitment to providing services to the poor. Although both advisers and operators can differentiate their bids by offering to provide additional services to the poor, we find that improvement over the minimum specified requirements rarely occurs due to the highly competitive nature of the bid processes and the prize of success and losses to be anticipated if the poor are supplied at less than cost.

We have found that PSP arrangements commonly operate under a heavily regulated “command and control” relationship rather than a de-regulated “business for profit” arrangement in which market forces work to satisfy demand. This means that the parties can too frequently engage in a servant and master relationship rather than as true partners sharing a common goal. Whilst intended to protect the poor from profiteering, badly designed regulation or confrontational contract terms may in fact contribute to the reluctance of the private sector to serve the poor.

A typical PSP contractual framework invariably, at some stage during its life, has conflicts and confrontations between operator and employer, with contentious issues often surrounding base levels of service, unforeseeable conditions and material changes in circumstances. Operating companies have more experience and can draw on wider resources than regulators. This marked imbalance of commercial and negotiating skills can result in an asymmetric relationship between operator and regulator, resulting in tedious and time-consuming regulatory wrangles and a hiatus in service delivery. This relationship hampers an early resolution of any underlying core deficiencies or the early improvement of services to the poor.

We have contrasted mechanisms for supplying water with those for consumer goods and other network services in which poor communities are better served. We conclude that market mechanisms can go a long way towards meeting demand in an unregulated market. These market mechanisms are essentially absent from most water sector PSP arrangements which are usually monopolies, which therefore tend to be highly regulated by the public sector, and grant exclusivity to the private sector.

It is becoming more widely appreciated that secondary suppliers can play a useful role in opening-up the market for water services, thereby simulating market mechanisms particularly for serving poorer communities. We see opportunities for harnessing these mechanisms under the PSP umbrella, as long as they are truly embedded and developed throughout the PSP process. However, we find that time and capacity constraints can militate against such an approach. We suggest that a degree of liberalisation within the regulated framework could facilitate the provision of water services to the poor, although this would require increased confidence in the economic effectiveness of secondary suppliers and their ability to meet appropriate standards.

We have prepared a simple gap analysis that presents the key steps in the typical PSP process and have contrasted these with a process that includes pro-poor strategies. We have identified that although additional time and resources would be needed to address the needs of the poor, these are small in comparison with the total cost of PSP.

As part of the PSP process, and with good intentions, advisers and planners consider in some detail the complex inter-relationship between investment, service standards and tariffs in order to achieve a sustainable operation. There is a danger, within the harsh competitive environment that these paper-based intentions can become divorced from reality and cannot realistically be achieved - the full extent of this unachievability only becoming apparent several years after the PSP arrangements are contracted. When cast in stone this can further fuel confrontation between the parties.

2.

Introduction

This report describes how PSP projects are prepared, and lists principal activities, constraints and the sequencing of events. We have drawn also upon the authors extensive knowledge and wide experience of PSP processes, but found it difficult to source significant amounts of specific procurement-stage project information containing definitive requirements to target improved services to the poor.

We draw the reader's attention to Section 1.1. The views expressed are without prejudice to any of the named parties.

3.

Preparation of PSP contracts

3.1 PSP Strategy Stage

The procurement of PSP arrangements mostly follows a '*Phase I stage*' that develops the PSP strategy and the overall direction of the water sector re-structuring exercise. It is followed by a '*Phase II stage*' that produces the actual contract bid documents. The issues involved in the strategy stage were described in '*Private Sector Participation and the Poor: 1 – Strategy*' in April 2000 and this report starts from the time when governments have decided to embark upon *Phase II* and prepare PSP bid documents.

The importance of ensuring that the *Phase I* strategy is right cannot be over-stated, as a failure to understand key legislative, financial and service performance requirements and expectations will be difficult and costly to overcome in *Phase II*. Key political support and commitment will also be required to manage a smooth transition from *Phase I* recommendations to the start of *Phase II* work.

The ability to influence the PSP process to specifically promote and improve services to poorer communities often lies within the scope of Phase I strategy work and becomes more difficult to achieve in the later stages of the PSP procurement process.

3.2 Selection of Advisers

Advisers will be appointed following a competitive bid process that may involve four or five competing firms. With evaluation and selection of winning bids on a combined technical and financial score, it is unlikely that a pro-poor focus in the Terms of Reference and monitoring system, would outweigh other technical and financial factors. Hence pro-poor strategies do not figure largely in the selection of advisers.

Work generally proceeds in accordance with the prescribed Terms of Reference and the adviser's proposal, and it is unusual for advisers to re-negotiate these.

Water sector restructuring consultancy work requires financial, legal and technical expertise, and it is therefore normal for a consortium of firms, working under a single lead firm, to unite to undertake such assignments. A consultancy team normally includes broad groupings comprising project management, financial analysis, project finance, water supply, institutional / regulation, and legal / contractual experts. Given

the expense of such large team structures, it can be difficult including additional NGOs and other pro-poor representatives within the team, unless specifically defined within the Terms of Reference.

The requirement for best value often translates into the cheapest price for the advisory services, which may not pay sufficient **attention to pro-poor strategies**. **This also implies that the entire process starts from a point of minimum required input.**

The inclusion of expert staff who have PSP experience and a workable knowledge of how to improve water and sanitation facilities for low-cost areas is clearly important for ‘pro-poor strategies’ to be successful, but the availability of such staff is often very limited.

3.3 Timescale for Advisory Commissions

The time period allowed for *Phase II* study work and the preparation of bid documents is normally defined by the client to fit within narrow windows of suitable political climates, and can be as little as three months in duration. Timescales are therefore short in relation to the spectrum of work to be undertaken, and do not allow for full due diligence and execution of the proper processes.

Tight time constraints inevitably lead to advisers prioritising their workload, and consequently it cannot be guaranteed that worthy causes and needs are covered to the same degree of detail as the core technical/financial issues. The ‘time factor’ may therefore be a significant reason for the historic under-representation of services to low-income communities in many concession contract documents.

3.4 Source Information for planning the PSP arrangement

Phase I reviews on PSP strategy will have established key information and requirements, but fuller detail and greater accuracy is required for the implementation stage. Every PSP project has a wide and often unique range of data requirements, which ideally will include:

Legal & Regulatory Information Requirements	Technical Information Requirements
<ul style="list-style-type: none"> ▪ Constitutional issues ▪ Primary legislation ▪ Powers of the client agencies ▪ Rights to award concessions ▪ Constitution of client agencies and shareholders’ agreements ▪ Regulatory powers and structures ▪ Ownership of assets ▪ Labour laws / Trade Union issues ▪ Rights of access ▪ Rights to disconnect ▪ Water Rights ▪ Powers of tariff setting ▪ Arbitration ▪ National policies ▪ Stakeholder information 	<ul style="list-style-type: none"> ▪ Assessment of engineering and financial data ▪ Existing Service Areas and existing Levels of Service ▪ Water consumption characteristics ▪ Water resources and water treatment assets ▪ Assessment of main planning and environmental drivers for future performance ▪ Assessment of the condition, available and required operational capacity of existing assets to achieve (1) current objectives (2) planning objectives and (3) environmental objectives ▪ Assessment of the effect of asset performance on operational efficiency,

Legal & Regulatory Information Requirements	Technical Information Requirements
	and vice versa. <ul style="list-style-type: none"> ▪ Staff numbers and conditions ▪ Existing improvement programmes ▪ Outstanding debts

In reality, only scant information is usually available. When coupled to a tight timescale and constrained inputs this seriously harms the completion of the full assessment process.

The poor particularly suffer from “information deficits” (ie. the gap between what is known and what needs to be understood). Good knowledge with readily available information about low-income areas before the start of the PSP process is a critical factor.

Funding agency requirements, their role and participation in the PSP process all need to be clarified by advisers, and sufficient time must also be allowed for receipt of comments from all donors.

The responsiveness of funding agencies is an important part of PSP procurement, especially in emerging economies. Funding Agencies are sometimes seen as being too distant during the PSP process, which can only hamper their ability to promote a pro-poor policy.

3.5 Legal and Regulatory Drafting

Legal drafting work will concentrate on supporting the PSP procurement process and work will centre on:

- the drafting of amendments to primary legislation to enable PSP to be implemented
- the preparation of foundation texts and bye-laws for new asset leasing company (if such options are applicable)
- the preparation of draft ordinances as necessary to implement the desired PSP option
- establishment of a regulatory framework and body

Time, quality and cost constraints at the critical planning stage preclude the opportunity for a wholesale re-drafting of primary legislation related to the water and sanitation sector. This would also distract from the fundamental goal of only accomplishing the minimal changes in order to support the PSP initiative.

Furthermore, any focus on peripheral issues (such as duty of care, obligations for universal supply, exclusivity of supply, legality of tenure etc.) risks these issues coming to the surface and side-tracking the PSP implementation process. Could this be the reason they are often left untouched?

3.6 Operators Selection Process

The process of selecting a PSP operator starts with bid documents containing outline requirements, follows with formal offer documents from the bidders and concludes with an acceptance agreement.

3.6.1 Operator Selection – bid documents

The purpose of bid documents is to allow potential bidders to detail their offers to a prescribed format that allows for proper comparison. The preparation (and administration) of bidding procedures is critical to ensure a transparent process that engenders confidence in the bidding operators that their significant investment in bidding will be made on a “level playing field”.

The assessments of technical and financial offers are conducted in a mechanistic fashion against a list of pre-declared parameters. The experience of nominated staff is examined with technical proposals, and these are assessed using weighting systems (see below).

Table 1 – Technical Evaluation Weighting System

(Typical for a concession contract in an emerging economy country)

Technical Area under consideration	Aspects of operation / Contract	Percentage weighting applied to each item (Typical range)
Strategy to reduce unaccounted for water	Bidders must detail their approach to the reduction of physical water losses from the distribution system and the non-physical losses associated with incomplete billing records, illegal users etc	15-25 %
Strategy to Achieve Levels of Service	Bidders must describe typical service improvements which centre on: (1) identifying constraints and improving the level of continuous supply; (2) broadening the effective use of metering; and (3) meeting supply pressure standards.	15-25 %
Asset Management Strategy	The approach to maintaining and developing the assets (covering new construction procurement, addressing growth and expansion, asset maintenance and renewal, and optimising capital and operational expenditure) need to be defined.	10 - 20 %
Strategy for Promoting Local involvement	Bidder's approach to long term local partnerships, ownership and customer consultations need to be defined	10 - 20 %
Strategy to improve water services to Peri-Urban areas	The strategy for peri-urban areas covering the management/rehabilitation/maintenance of standpipes, a reduction in the mark-ups to the retail price of water and any other work to meet National water policies needs to be defined.	10 – 16 %
Human Resources Strategy	Approach to employment terms and conditions, and local training	10 – 14 %
	Total =	100 %

A simple way of promoting low-income areas is by assigning a greater percentage weighting within the technical evaluation. However, this detracts from other technical areas, and consequently may only have a marginal impact.

3.6.2 Draft contract

The bid documents include a draft Contract that sets out the contractual, legal and regulation regime under which the PSP operator will work. Major elements include:

- risk identification, management, mitigation and sharing
- services to be provided by the operator, and obligations of the lessor
- service standards, and technical and financial auditing of performance during the contracts
- the regulatory process, criteria for modification of the tariff, and indexation
- “trigger” arrangements for increasing the scope of the services, or extending the stake or risks of the private investor
- the basis for and methods of payments
- closure or termination arrangements

There is a belief that the draft contract is only an initial framework to start proceedings and will be refined in negotiations towards the end of the procurement process. However, given the harsh commercial realities of bidding for competitive commissions this rarely happens and there is little material change in final service delivery requirements when compared to that set out in the draft contract. Any changes to contracts should be identified by bidders as conditionalities and should be evaluated in monitoring.

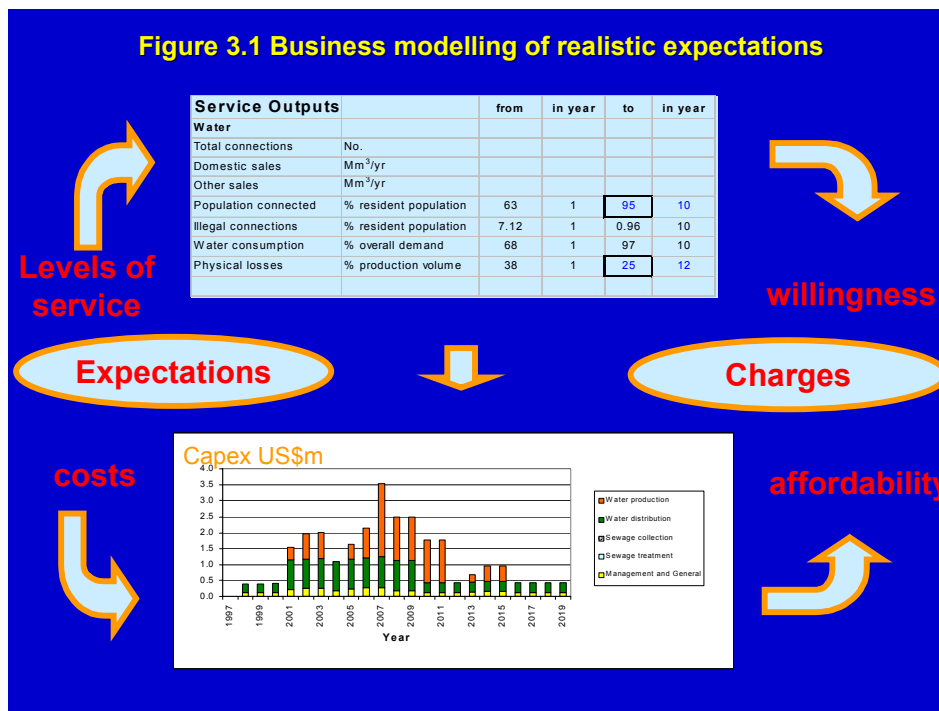
3.6.3 Business Modelling of Investments and Tariffs

Central within the bid documents are the **minimum service targets** and their **maximum timescale** for achievement. These will normally be predetermined by government but the Adviser is expected to assess whether they are achievable or whether they would be detrimental to the bidding process. Expectations are balanced against charges through a process of business modelling of levels of service, costs and charges as shown below.

Business modelling of the long-term future of service delivery depends on both operational and financial parameters. On the operational side, service outputs drive capital and operating expenditure, and the critical modelling parameters are the efficiency with which these can be delivered. Critical financial inputs are the cost and terms of borrowing, the availability of equity, and affordability

High-level historic data is modelled to “balance” costs of operational / investment / service level improvement / charges, and then interpreted from that output into an appropriate form as contractual requirements.

The financial modelling balances the broad cost estimates of refurbishment/expansion/provision of new services, against income allowing for water operations in low-income communities.



The scarcity of information, and occasionally understanding, can make it difficult to properly include the informal sector within the financial modelling exercise. The degree of services provided by operators in secondary markets should be assessed.

It is also at this stage that political weighting or financial subsidies could be added to permit a greater degree of expansion in services to the poor.

3.6.4 Service Standards – Formal and Informal Sectors

Service targets are the standards of service that should usually be achieved for a specified population of consumers by prescribed dates. For the formal sector these can be confidently stated. However, a full appreciation of how the informal sector operates is needed to state corresponding standards for the informal sector.

Not only is there an absence of guidance for specifying service standards for the informal sector, but there can also be a reluctance by advisers and governments to regularise such standards in the informal sector due to their quasi-legal nature.

3.6.5 Typical Service Standards in Emerging Economies

Considerable effort is rightly placed on defining service standards and this is heavily linked to financial modelling. There is a wide range of operational service standards which are typically grouped as:

1. Mandatory standards governed by legal obligations arising from national or international law, notably water quality and environmental standards

2. Technical and operational standards relating to serviceability as perceived by customers, with particular reference to availability and continuity of water supplies and Operational & Maintenance standards such as asset renewal, leakage or capacity enhancement.
3. Customer service standards relating to efficiency of customer and revenue management processes.

In most emerging economies the universality of service standards is not an economic possibility, and whether officially recognised or not, supply areas generally receive different levels of services. PSP bid documents define levels of services by the facilities provided. A typical range of service classes is shown below:

Table 2 - Levels of Water and Sanitation Services

(Typical for service classes in an emerging economy country)

Level of Service	Service Provided	Water Supply	Sanitation
L5	Full Service (High Use)	Metered connection for in-house supply (high use).	Full waterborne sanitation. Each dwelling connected to sewer with full facilities available.
L4	Full Service level	Metered connection for in-house supply.	Full waterborne sanitation. Each dwelling connected to sewer with full facilities available.
L3	Medium Service level	Metered standpipe per site.	Toilet with superstructure and washbasin connected to waterborne system.
L2	Low Service level	One metered standpipe within 100m of a household or low volume yard connection	VIP latrine
L1	Minimum Service level	One metered standpipe within 200m of a house or Communal Tank	VIP latrine
L0	Emergency and Temporary Settlement Service levels	Temporary storage tanks with communal taps, or metered standpipes or Water Tankers	One chemical toilet or shared VIP to be provided for every 7 dwellings or shared ablution blocks

Tender documentation for operator selection, identifies current standards and details future standards and the timescales for their achievement. However good such an arrangement for procuring services is, there is a danger that it becomes a “paper exercise” with little correlation to present standards or those realistically achievable by the targeted dates. The true reality of this gap only becomes apparent some time after the PSP arrangement is contracted.

It is evident that water sector PSP arrangements can be highly detailed with many differing service requirements, payment schedules and penalty provisions. It can therefore rely upon extensive regulatory regimes with “command and control” contractual provisions that contrast markedly with other services that

have found growth by adding economic value (and economic self-interest) into their business mentality.

3.6.6 Service Targets

Conventional definitions of minimum service targets to the formal sector include:

- the quality of service currently provided in respect of key parameters (*base service*)
- the desired target levels of service as percentage compliance against declared standards (*service targets*)
- timetables for achieving targets and for dealing with inequalities in service (*programmes*).

Such minimum service targets and maximum timescales may be bettered.

In the harsh competitive environment (where there are no rewards for second place) bidders will offer the minimum requirement, especially when there is limited information on offer.

3.7 Contracting the Operators

3.7.1 Bidding, Evaluation and Acceptance

Operators may choose varying tactics when structuring their bids. It is possible that long concession contracts will be seen as a series of shorter-duration contracts, and in the knowledge that there will inevitably be variations and re-basing of prices, bidders may choose to submit a reduced price in order to win the “first short contract”. There may also be strong “market entry” factors for some concession contracts as Operators vie for a foothold in new regions.

Offer documents will be scrutinised for compliance with the requirements of the bid documents and undergo evaluations in accordance with published award criteria. Advisers will prepare an evaluation report that contains recommendations for award of the PSP contract.

A series of negotiations with the successful bidder may take place to confirm proposals and resolve outstanding issues. The procurement process is completed with financial closure and award of contract.

Host countries may have differing legal and cultural approaches to procuring services and the processes of bidding, assessment and award can vary. Financial issues such as financing of investments can dominate this part of the procurement process. As a result enhancing services to the poor can have low priority at this point.

3.7.2 Local Company

It can be politically and commercially advantageous to require International Operators to create a local operating company for the execution of PSP contracts. However a risk remains that parent companies distance themselves from the daily operations on

the ground, and that responsibility is lost as their “brand” becomes obscured under a local operating company name.

Whilst governments may be under the impression that the PSP Operator will be an international company, in reality it can be locally established company managing water services. Parent Company Guarantees and Performance Bonds should be included in the contract

It is important to ensure that, in selecting and translating a competitively-selected international operator to a local representation, commitments to deliver service obligations prescribed at the bidding stage are maintained.

4.

Comparison with Other Sectors

We consider that a brief comparison of how other services and products access the poor and see the poor as customers might contain valuable lessons for water PSP arrangements.

Utilities that could be considered include:

- electricity
- mobile telephones

High demand for these services exists and is met by new supplies. These utility services benefit from having developed workable pre-pay metering devices and tariffs that are expressly linked to usage. Initial connection charges are lower than for water services. Operators generally have cheaper infrastructure and lower distribution costs. Government involvement is high, but regulation less obtrusive. Typical consumer products where there is ample market penetration in poorer areas include:

- cigarettes
- soda drinks
- baby milk powder

Supply-side characteristics of these products include ample supply (both in terms of volume of goods and numbers of vendors/outlets), affordability of the wholesale goods, low start-up costs for sellers and low distribution/management costs, legal status and locality.

Demand-side characteristics include desirability, longevity of product image (i.e. brand image), wide understanding of the benefits brought by the product, overall affordability, legal status and locality. These products have an abundance of secondary sellers that stand alongside (often immediately outside) larger retailers with little or no conflict. There is little government involvement.

Different market mechanisms exist, but a pattern of openness, ample supply-side characteristics, affordability, legal status and locality exist.

Unanswered questions for water are how to replicate the low costs, accessibility, desirability and legality of the products and services briefly illustrated, and we suggest that further lines of enquiry are required.

5.

Gap Analysis

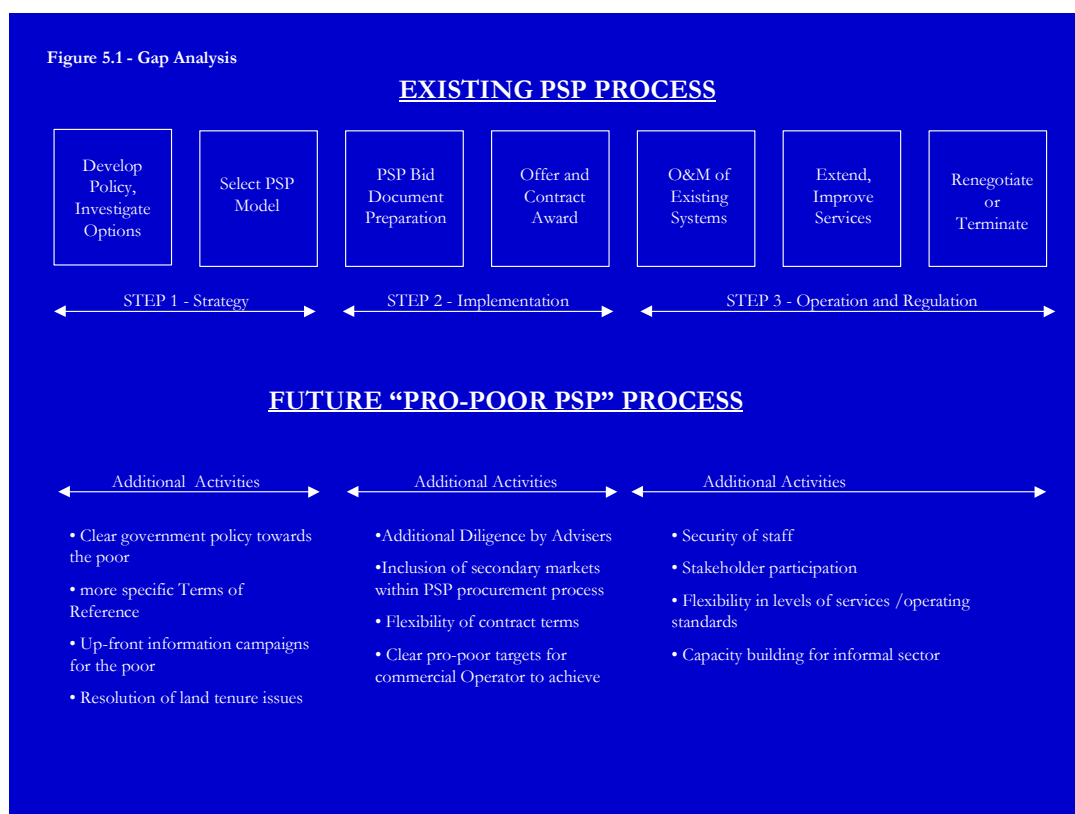
The transition from a public to private water sector is a continuum process separated by key events. It can be represented by a number of discrete stages, grouped into the following three broad steps:

- Step 1 – Planning and Consensus of type, scale and scope of PSP
- Step 2 – Procurement and Implementation of PSP
- Step 3 – Operation, Regulation and Termination (or renegotiation)

5.1 Additional Activities

This process is shown on Figure 5.1, but if pro-poor strategies are to be added then additional resources are needed to resolve constraining issues. These additional pro-poor activities are also shown below and include more specific Terms of Reference, a clear strategy towards the inclusion of capacity building of the informal sector and the development of flexible but targeted contracts. Importantly, pro-poor strategy activities overlie all three broad steps and hence delivery of pro-poor services must be designed from

Figure 5.1 - Gap Analysis



5.2 Additional Resources

The resource implications of addressing the supplementary pro-poor issues are highlighted below in relation to resources required for the full PSP process. They are shown to be small in comparison with the total cost and duration of PSP.

Stage	Task	Additional Time	Cost Implication	Running Time (Years)
Selection of Advisers	More specific Terms of Reference	Minimal	Low	1
Preparation of Bid Documents	<ul style="list-style-type: none"> ▪ Better information on the poor ▪ Further diligence by Advisers 	Medium	Low	2
Bidding Stage	Further diligence by Bidders	Medium	Medium	2 ½
Award Stage	Additional commitment to pro-poor policies	Minimal	Low	3
Delivery stage	Commitment to deliver Capacity building of informal sector	Medium	Low	up to 30 years

6.

Conclusion

We have identified some recurring themes in relation to provision of services to the poor. Shortcomings are not detailed as criticisms, but discussed in the interest of sharing of knowledge and improving services to the poor in the long run. In examining the relationship between key stages in the procurement of water and sanitation PSP contracts and the effects on the poor we have found:

- the selection of advisers can translate best value into most economically advantageous bid, which implies that the entire process starts from a point of minimum required input.
- scant information coupled to a tight timescale and constrained inputs can harm the completion of the full assessment process, particularly for the poor.
- time, quality and cost constraints can preclude whole-scale re-drafting of primary legislation related to the water and sanitation sector. Focus on peripheral issues (ie. legality of land tenure) can risk delaying the PSP implementation process.
- the commercial realities of service delivery through a commercial contract often mean that there is little incentive for enhancing service standards in comparison with those set out in the contract.
- the harsh commercial realities of bidding in a competitive environment can mean that bidders rarely offer improvements over the minimum requirement.
- water sector PSP arrangements often rely upon “command and control” contractual provisions that contrast with other services which appear to grow by adding economic value (and economic self-interest) into their business mentality.
- the resource implications of addressing supplementary pro-poor issues are considered to be small in comparison with the total cost and duration of PSP.

