

privatesector

Doing Privatization Right

What It Takes to Maximize Gains in Low-Income Countries

A recent study examining privatization results in four Sub-Saharan African countries yielded two broad conclusions: First, privatization is not easy to do, and getting it right can be tough in low-income countries. Second, if privatization is done right and there is a little luck, it can lead to substantial welfare gains that are reasonably and equitably distributed across stakeholders—consumers, workers, governments, and owners or operators.

To develop a better understanding of the impact of privatization in low-income countries, a recent study looked at eight privatizations in four Sub-Saharan African countries (table 1).¹ Results were measured at three levels: the transaction, to assess the time taken to get the deed done and its sustainability over time; the firm, to assess efficiency effects; and

the stakeholders, to assess impacts on consumers, employees, governments, and owners or operators. A welfare analysis measuring the relative distribution of net benefits among stakeholders was carried out for the two cases that had the data and sufficient change to warrant such an analysis—Côte d'Ivoire electricity and Senegal water.

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Table The eight transactions studied

| Transaction | Type of privatization | Employees | Competition in sector? |
|---------------------------|-----------------------|-----------|------------------------|
| Côte d'Ivoire electricity | Lease | 3,707 | No |
| Mozambique water | Lease | 1,200 | No |
| Senegal airlines | Sale, majority | 120 | Yes |
| Senegal electricity | Sale, minority | 1,700 | No |
| Senegal water | Lease ^a | 1,480 | No |
| Uganda clay | Sale, full | 307 | Yes |
| Uganda telecoms | Sale, majority | 1,890 | Yes |
| Uganda water | Management contract | 512 | No |

a. Affermage variant.

Transaction results

Transaction success appears harder to come by in Africa than in high- and middle-income countries. Only three cases—Côte d’Ivoire electricity, Senegal water, and Uganda clay—were unqualified successes, concluded on the first try and sustained over time with no major contractual or transparency issues arising.

Others took several tries or were difficult to sustain. The sale of Senegal airlines took four attempts over three years, and Uganda telecoms three tries over seven years. The first lease contract in Mozambique water ended abruptly over disputes about pricing, investment, and bidding information, and negotiating a new contract took two years. In Uganda water both management contracts were fulfilled, but neither party wished to renew the first contract, and agreement on price could not be reached in the second. The Senegal electricity sale contract was canceled after a mere 18 months following investment and pricing disputes; a later attempt to reprivatize the company failed.

Both external and internal factors explain these results, as shown by a comparison of two cases in the same country: Senegal water (a success) and Senegal electricity (a failure). Some factors in the failure for electricity were beyond policymakers’ control, including the strategic partners’ decision to disengage from Africa and the entry of a new government in 2000 that regarded the privatization as a mistake.

Internal factors were also important. Among these were design flaws in the first electricity bid, including a tender based on offer price with little weight given to bidders’ capabilities and experience; a failure to specify investment and electrification targets in the contract (though they were specified in the tender documents); and a failure to require a dominant strategic partner, leading to disputes about strategy and staffing between the winning consortium’s two partners. Technical due diligence (by both buyer and seller) was limited compared with that for the water privatization, and the privatization process excluded workers and other stakeholders. Insufficient flexibility in negotiations finally led to the departure of the owner-operator.

The study yielded inconclusive evidence on two factors commonly associated with transaction success:

- *Competitive bidding.* Côte d’Ivoire electricity was successful despite negotiation with a single bidder, while Senegal electricity was the least successful of the cases despite competitive bidding.
- *An independent regulatory agency.* Problems arose in the two cases with an independent regulatory agency (Mozambique water, Senegal electricity), while in the two without such an agency major contractual disputes did not arise (Côte d’Ivoire electricity) or were settled amicably (Senegal water).

Firm results

Efficiency gains, by contrast, seem easier to come by, mainly because of poor initial conditions in the companies privatized. Four cases had gains ranging from considerable to dramatic. Improvements in Côte d’Ivoire electricity began when independent power producers came on line and continued (but fell off) after 2000 despite civil unrest in the country. The gains in Senegal water came from new investments and a tough, creative incentive structure built into the contract. In Senegal airlines a previously nonoperational company saw increases in traffic, labor, and revenues, though not all the gains are attributable to privatization (the company was positioned to take over markets abandoned by the exiting Air Afrique). In Uganda clay the first two years saw little change, but efficiency and capacity doubled after the appointment of a new manager and investment in a new kiln.

Three other cases also had improvements in performance, though the effects of privatization were less clear. In Uganda water, performance improved (in collection efficiency and new connections) under the two management contracts, but it was also improving in the three years before privatization as a result of a new water law and a general upturn in the economy. The government’s new policy of paying its debts and a drop in connection charges also contributed.

In Uganda telecoms the well-known gains came largely from cellular, gains that had more to do with competition than with privatization because the privatized company was late to enter

the market. The number of fixed lines doubled and efficiency rose after privatization, but because the fixed line market was less than a tenth the size of the cellular market these gains were small compared with the cellular gains from competition.

Mozambique water showed some improvement (in water distributed and paid for) despite adverse external circumstances (flood, cholera outbreak), the departure of the lead operator, and a two-year delay in getting a second contract into place. But incomplete preprivatization data preclude a firm attribution to privatization.

Senegal electricity was the only case with no impact, stemming from the brevity of the transaction and the management difficulties that plagued the consortium.

Stakeholder results

Common perceptions notwithstanding, consumers lost in none of the eight cases (table 2). They had modest gains in all three competitive cases (Senegal airlines, Uganda clay, Uganda telecoms) because while privatized firms grew rapidly, lag effects and heightened competition limited consumer benefits. Consumers had major gains in three of the five noncompetitive cases (Côte d'Ivoire electricity, Mozambique water, Senegal water) because of increases in access to services and in the quantity supplied. Price effects were minimal because access to investment capital allowed expanded coverage with only moderate price increases. The moderate gains in Uganda water reflect the counterfactual: consumers would have done as well without privatization because of good public

sector management. The zero gains in Senegal electricity stem from the failed transaction.

Results for workers show greater variance. Workers were major net winners in the two cases—Senegal airlines and Uganda clay—where output price was not regulated and where greater profitability and capacity utilization translated into higher employment and wages. By contrast, workers were modest net losers in Mozambique water and Senegal water because both companies reduced employment before privatization. Three cases showed no significant net impact because prior voluntary departures were offset by higher wages and employment after privatization (Uganda telecoms), because there was no change (Uganda water), or because the transaction failed (Senegal electricity).

Government was a major winner in Côte d'Ivoire electricity and Senegal water. Direct and indirect taxes on the primary market accounted for nearly 80 percent of the gains in the first case and 30 percent in the second, while ownership return accounted for 20 percent in the first and 60 percent in the second (with the rest from donor support). Government was also a major winner in the three divestiture cases—Senegal airlines, Uganda clay, and Uganda telecoms—where gains from greater tax revenue and ownership return exceeded the sale price. Government had a modest gain in Senegal electricity (despite little material benefit from the sale) because it bought back the shares at a lower price than it sold them for and received donor funds for the second sale attempt (which later failed). Uganda water was the only case with modest losses, reflecting

Table Stakeholder impacts

| Transaction | Consumers | Workers | Government | Owners or operators |
|---------------------------|-----------|---------|------------|---------------------|
| Côte d'Ivoire electricity | ⊕⊕ | ⊕ | ⊕⊕ | ⊕⊕ |
| Mozambique water | ⊕⊕ | ⊖ | ○ | ⊖ |
| Senegal airlines | ⊕ | ⊕⊕ | ⊕⊕ | ⊕⊕ |
| Senegal electricity | ○ | ○ | ⊕ | ⊖⊖ |
| Senegal water | ⊕⊕ | ⊖ | ⊕⊕ | ○ |
| Uganda clay | ⊕ | ⊕⊕ | ⊕⊕ | ⊕⊕ |
| Uganda telecoms | ⊕ | ○ | ⊕⊕ | ⊕⊕ |
| Uganda water | ○⊕ | ○ | ⊖ | ⊕ |

⊕⊕ Major net gains ⊕ Modest net gains ○ No significant net impact ⊖ Modest net losses ⊖⊖ Major net losses

annual fee payments to the management contractor.

In Côte d'Ivoire electricity, Senegal airlines, Uganda clay, and Uganda telecoms private owners or operators came in, turned things around, and benefited from greater profitability. In Senegal water the operator performed well but earned little reward because of tough incentive clauses in the contract. In Uganda water the operators were paid, but their reputation suffered because of a less than stellar performance. In Mozambique water one private partner lost (and left the consortium) while the other two stayed on but with accumulated capital losses, making them modest losers. And in Senegal electricity the partial owners left and suffered both capital and reputational losses, making them major losers.

Finally, there were substantial overall welfare gains in both cases for which a full welfare analysis was done. In Côte d'Ivoire electricity welfare gains were evenly distributed, with government, domestic consumers, foreign consumers, and owners each getting 22–28 percent of the pie and workers getting 6 percent. Senegal water showed greater variance, with consumers receiving nearly 70 percent of the net gains (from an increase in water consumed) and government receiving 30 percent. Workers lost, but their losses were only a small percentage of the winners' gains, while the private operator made no gains because of the incentive regime.

Lessons

The diversity of cases and outcomes precludes easily generalizable lessons. But the underlying lesson is the need to focus on “doing privatization right” by:

- Ensuring that evaluation processes account for bidders' technical and managerial capabilities rather than price alone. Rigorous due diligence, clear bidding and evaluation criteria, and independent evaluators all help in this.
- Developing the right incentive structures to achieve performance targets. A big factor in the success of Senegal water was a two-part compensation structure with many of the efficiency properties of the better-known two-part utility pricing model.
- Relying less on standard regulatory models to resolve disputes and more on trust based on solid due diligence and consensus building. Points to bear in mind: Provide sound information so the buyer knows what it is getting and the seller knows what it is selling. Since perfect information is often unobtainable, allow for flexibility and adjustments in the contract. And since disagreements are still likely, ensure that there is someone to play the role of “honest broker.”
- Recognizing that success in achieving equity depends more on policy choice than on whether the country is rich or poor. To minimize workers' losses, policymakers can preclude firing or provide voluntary separation packages. To minimize consumer losses, they can use financial models to target sustainability without major price increases. And to maximize government gains, they can focus less on the initial price and more on the much larger downstream returns from greater tax revenue and residual state ownership.

Note

1. *Privatization* is broadly defined to include transfer of management or ownership from the public to the private sector through management contracts, lease and affermage contracts, concessions, and full and partial divestitures. Cases were selected on the basis of three or more years of postprivatization history, access to pre- and postprivatization data, and a mix of countries and sectors.

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