

**COMMONWEALTH OF PUERTO RICO
OFFICE OF THE COMPTROLLER**

**SEVEN FUNDAMENTAL PHASES FOR A SUCCESSFUL PRIVATIZATION
(The Cycle Of Privatization)**

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INTRODUCTION

The privatization topic has generated great controversy at the international level since the decade of the 1980's. However, it has become necessary to reconsider the activities in which the State should or should not intervene, such as:

- ❑ poor performance of state managed enterprises
- ❑ concept of the state's role in the economy
- ❑ need of investing more in projects of infrastructure, with the purpose of expanding and improving the quality of services
- ❑ increasingly greater control imposed by budgets
- ❑ technological advances that reduce the scope of services previously considered natural monopolies

However, the factor that has contributed the most to the feasibility of the privatization processes is the access to capital markets. It has done so by providing *equity capital* for projects of infrastructure.

Nevertheless, the success of privatization is not guaranteed. There is evidence of both successful privatization and privatization without any results or with negative or ineffective results. Other times, even when operational efficiency and foreign capital investment are achieved at the beginning, the customers have not attained economic benefits. In that case, what are the decisive aspects that must be taken into consideration on analyzing, planning, implementing and evaluating the privatization?

The Office of the Comptroller has identified a number of phases that are classified in what we have called "the cycle of privatization" and that are advisable to consider in order to reach a successful privatization.

THE SEVEN FUNDAMENTAL PHASES

1. Laws
2. Plans and RFP's
3. Market Restructure
4. Regulatory Function
5. Information
6. Review of Rates
7. Rollback Plan

1. LAWS — Promulgate laws that make the privatization feasible, so that they produce socioeconomic benefits, protect the patrimony of the State and guarantee the welfare of citizens

The laws must establish clearly and completely the objectives or purposes that each privatization seeks. Purposes and objectives such as:

- ❑ general increase of Puerto Rican entrepreneurial competition
- ❑ increase in the efficiency and quality of services, product and prices of the municipal or state activity to be privatized
- ❑ elimination or reduction of the public debt
- ❑ elimination of political intervention in the decision making process of the privatized entity or industry
- ❑ access of the privatized entity to financial markets for the development of the infrastructure

These are some examples of the objectives and purposes that the citizenship must be aware of in any privatization process.

It must be taken into consideration that the funds or benefits obtained from a privatization should not be exclusively used to pay current debts. The reason for this is that current debts are recurrent. Also, the socioeconomic development is not enhanced, as the debt would be transferred to the people.

The laws approved on privatization should also guarantee the transparency of the process. For example:

- ❑ establish the need of a proposal application process (although the laws do not have to be specific as to the procedures to be followed)
- ❑ guarantee the proposal application process to a greater number of proponents
- ❑ guarantee the availability of information and data to any qualified proponent.
- ❑ require the publication of the method, assessment and price of the privatization of the product, service or public activity, as well as the cash funds obtained from the transaction
- ❑ require adequate protection of proposals to guarantee equal competitiveness among proponents
- ❑ request that the process be published through television

The privatization laws should also establish a maximum term for contracts and should create the function of a regulator². This official must watch for the compliance of the terms and conditions of the contract and of the privatization law,

² For example, in the case of a privatization related to the aqueduct and sewer utility, the Office of Commissioner of Waters could be created.

as well as control of rates, consumer protection and other functions assigned by law thereto.

The process of analysis and the legislative process should take in mind if the participation of investors and local companies will be required. It should also consider essential matters such as: rates, rights and labor changes, planning, ecological impact, citizen education and deposits.

2. PLANS AND RFP's — Establish a request for proposal process to guarantee the largest possible participation, that will generate an adequate Request for Proposal for the specific type of privatization, and that guarantees the transparency and objectivity of the process

The request for proposal process should begin with the selection of specialists experienced in the privatization of entities similar to the one that will be privatized. These experts- local and international- SHOULD NOT be affiliated to any proponent who is participating in the privatization process. The companies and entities that have advised countries where privatization has been successful should be taken into consideration.

The Request for Proposal should include, among others, aspects such as:

- ❑ method of review and selection
- ❑ proponents' financial qualifications
- ❑ short and long term service expectations (proponents will be in the obligation of presenting their infrastructure development plans)
- ❑ analysis of the financing that the infrastructure will require during the term of the privatization
- ❑ model of the privatization contract

The method for request of proposals should guarantee compliance with the conditions and requirements established by the Request for Proposal. Although there are several methods, that of **separated envelopes** is recommended. The proponent will include his technical proposal in one of these envelopes, and his economic proposal, in the other. The proposal evaluation process is performed in two phases. In the first phase, compliance with technical and financial requirements specified in the Request for Proposal will be analyzed. At this stage, it is essential to rely on the assistance of any technical advisors that may be needed. To reduce or eliminate subjectivity in the evaluation process, it is not recommended to compare proposals. All the proponents that comply with the requirements of the first phase participate in the second phase of the process consisting in selecting the best economic proposal.

One of the more objective methods to select the contracts of privatization of utilities consists in selecting the proponent that quotes the lowest rate during a predetermined number of years for which he would be willing to sign the contract. It

is recommended that the media be present during the process of opening the envelopes with the economic proposal.

3. RESTRUCTURE OF MARKET— Restructure the entity in a manner that will guarantee its competitiveness

International experience has demonstrated that privatizations do not guarantee by themselves any economic benefit or more and better services, even when these benefits could be present at the beginning. The entity must be restructured in order to be competitive and avoid monopoly. For example, a geographical restructuring can be performed, or operations can be divided.

However, one must consider that an inadequate fragmentation could reduce or eliminate the proponents' interest because it eliminates what is known as economy of scale. For example, the agency that managed the aqueducts and sewers in a South American country was fragmented, and the municipal governments assumed this responsibility. This brought about the politization of the systems, an accelerated deterioration, and inability to develop the infrastructure. Then, on trying to privatize these entities, in the smallest or less privileged municipalities, the enterprises dedicated to render these services did not show any interest in acquiring them.

4. REGULATORY FUNCTION — To establish an entity to regulate the service to be privatized

It is essential to establish a regulatory entity to prevent enterprises from profiting or exploiting their monopolistic activity.⁴ The main consequence of said activity is the possibility of continuous increases in the rates. However, the Regulator's function is not restricted to the control of rates, it is also essential to watch for the compliance of laws, regulations and commitments entered into by the privatizing entity. It should, among other functions:

- protect the interest of the citizens (for example, avoid abuse and discrimination, watch for the quality of the service and for the transfer of benefits that are accrued due to the sale of assets)
- foster the economy and efficiency of the enterprise (compare the performance of the objectives established in the contract and with those of other enterprises and sectors)
- foster competition
- coordinate its function with that of other regulatory agencies (for example, with those having to do with health and environment)
- decide in the case of disputes and claims and enforce the regulating entity's decisions

The Regulator should not be responsible for establishing environmental or health policies.

⁴ Especially when it pertains to natural monopolies, for example, the aqueduct and sewer services.

The position of Regulator should be independent. He could be appointed by the Executive with the approval of the Legislature and for terms of 6 to 10 years. The Regulator should submit annual reports to the Executive and the Legislature.

The Regulator could rely on the assistance of a Users Council and of regional committees that would represent users' concerns, besides helping to investigate complaints.

The regulating entity must be separated from the privatized entity. This will foster impartiality of the parties and the efficiency or effectiveness of the Regulator's controlling function.

5. INFORMATION — The laws, regulations and the privatization contract must guarantee that the privatizing entity's information is presented in a complete, accurate and regular manner

The policies that regulate an enterprise that is assuming a public service, should be similar to those of an enterprise operating under the policies of the *U.S. Securities and Exchange Commission*. For example, they should require:

- information on the nature of the enterprise (their operations, services, experience, education and salaries of their major executives)
- quarterly financial reports and, audited annual financial reports
- information on the commercial activities of subsidiary enterprises
- annual report on the development and research activities
- information on the commercial activity required by the home state or country of the enterprise

Nevertheless, the privatizing entity can be requested to provide more information according to the laws and regulations to which they are subject.

6. REVISION OF RATES — Establish the rates, criteria and procedures to evaluate the petitions of increase of the service rates.⁵

In most of the cases, a petition of an increase in rates is used to recover investments in infrastructure.⁶

⁵ The absence of specific norms and criteria may provoke situations of international arbitration or litigation, and consider the contract terminated through legal means. For example, The Aguas de Aconquija Company in the Province of Tucumán, Argentina, took the dispute to an international arbiter due to petitions of rate increase that were not granted. The case of arbitration, initiated in 1976, ended in February 2001, but with the arbiter's decision of continuing the dispute in local courts of the Province.

⁶ In some cases, when international capital is used for financing the project, and there is a considerable devaluation of the currency used by the country that receives the service, the contractor requests a rate increase to pay for the difference in the loan, arising as a consequence of the currency devaluation.

All these criteria and procedures should be detailed in the privatization contract and it is the Regulator's duty to watch for its compliance.

7. ROLLBACK PLAN — Design a plan whereby when the privatization contract is terminated, the entity may transfer to the state or other privatization entity thus reducing moral hazard

When a monopoly is being privatized without restructuring the privatized entity, one of the major questions is what is known in economy as *moral hazard*, or moral threat which victims are the state and the economy. Moral hazard occurs when the state maintains a bad business because it cannot justify its failure. This provokes an unbalanced transaction in favor of the investors, by giving inappropriate incentives and by using the resources and productivity for the disadvantage of the state and the citizens. For example, on searching for greater profits, the privatizing entity may assume unreasonable hazards, because it presumes that the state will respond with its funds (by assuming the loss or through subsidies) inasmuch as the service to the taxpayers or users cannot be discontinued.

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