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### **Guidelines for Performance-Based Contracts between Water Utilities and Municipalities**

**Lessons learnt from Eastern Europe, Caucasus and  
Central Asia**

#### **Executive Summary**

Information document submitted by  
the OECD/EAP Task Force Secretariat



## EXECUTIVE SUMMARY

The present report summarises the major lessons learnt from the experience with performance-based contracts in the water supply and sanitation sector in selected Eastern Europe, Caucasus and Central Asia (EECCA) countries. The report also seeks to highlight the main achievements of and challenges facing the EECCA countries in designing and implementing such contracts. The analysis of the report is based on five case studies: two in Armenia (a management and a lease contract), two concession contracts in Ukraine and one case study from Kazakhstan (near full divestiture). The OECD Guidelines for Performance-Based Contracts between Municipalities and Water Utilities in EECCA provided the analytical framework for these assessments. The present report builds upon the Guidelines, further deepening the analysis on the basis of specific examples from the reviewed contracts. The report also highlights some issues which were not present in the first version of the Guidelines. The full version of this book is available from OECD Library: [www.oecd-ilibrary.org](http://www.oecd-ilibrary.org).

### Background

Over the past decade, the countries of Eastern Europe, Caucasus and Central Asia (EECCA) have undertaken significant economic and market reforms, including in the water supply and sanitation sector. Despite the reforms, however, the governments of these countries are still experiencing serious challenges in providing high-quality water services to their population. The poor state of water infrastructure in EECCA is a result of many years of neglect and under-investment as well as inefficient management practices in water utilities.

To improve the performance of water utilities, some countries in the region have turned to performance contracting. Performance-based contracts (PBCs) are negotiated legal agreements between governments/municipalities and publicly or privately operated water utilities that deliver public water supply and sanitation services. Generally, performance-based contracts are developed to help define the utility development goals. Unlike traditional government contracts that focus on inputs, performance-based contracts focus on results, thus encouraging operators to be innovative and to find cost-effective ways of delivering services. More specifically, these contracts include time-bound performance targets against which the performance of the operator is measured and good performance is rewarded while poor performance is sanctioned. If designed properly, performance-based contracts can help lay the basis for the long-term sustainability of the utilities, increasing their efficiency and creating conditions where investment capital can be attracted.

To support EECCA authorities that will contractualise their relationship with their water utilities, in 2006, the OECD EAP Task Force developed “*Guidelines for Performance-Based Contracts between Municipalities and Water Utilities in EECCA*”. These Guidelines address the key elements that need to be considered in connection with the preparation, implementation and periodic revision of a successful performance-based contracting mechanism (such as, among others, contracts for service, management, lease, concession). The major elements usually include: performance indicators, tariff related issues, contract monitoring, mechanisms for conflict resolution, conflict enforcement, risk mitigation.

The present report builds upon the Guidelines and further complements them by providing specific examples from selected EECCA countries. The purpose of the report is to present a summary of the major lessons learnt from the reviews of five performance-based arrangements in Armenia, Ukraine and Kazakhstan and identify good practices for designing and implementing such contracts. In addition, the report discusses some new issues which were not covered in the first version of the Guidelines. Apart from including a new chapter on contract preparation, some of main contractual elements (e.g. tariff setting and revision, contract enforcement, risk management) were additionally developed.

The five case studies cover most of the existing types of performance-based contracts that exist in the water sector: they range from a management contract (for the Armenia Water and Wastewater Company with the French company SAUR), a lease contract (for the Yerevan Water Supply Company with the French company Véolia Water) in Armenia, concession contracts in Ukraine (with domestic private operators in the towns of Berdyansk and Kupyansk), and (near full) divestiture in Kazakhstan (the water utility in the city of Shymkent is owned by a domestic private operator).

Given the huge number of EECCA municipalities with responsibilities for managing water infrastructure, the penetration of performance-based contracts in the EECCA region is still rather low, compared to other regions of the world. Most often, it is some nascent types of contractual arrangements that exist between the municipality and the operator. One of the reasons may be the insufficiently developed regulatory basis in many of the EECCA countries but it may also be the lack of capacity of municipalities (human and financial) to embark on such, sometimes rather, complex arrangements.

### **Major lessons learnt from experience with performance contracting in the reviewed countries**

Of the five reviewed case studies, the two Armenian contracts are at a more advanced level of implementation compared to the Ukrainian concession contracts which have hardly taken off the ground at the time of writing this report. As such, the Armenian contracts provide a number of useful insights into how contracts work in real life. The experience of the Armenian government with performance contracting shows that no contract, no matter how well designed, can provide for all possible cases that can occur during implementation. For this reason, it is important that the parties maintain good working relations which can help solve problems in a less formal but sometimes more efficient manner.

Some of the major lessons which emerge from the review of the case studies and the particular contractual elements deal with the issues listed below:

- The legal and institutional framework for water and sanitation services;
- The contract preparation stage;
- The definition and selection of performance indicators;
- Tariffs, tariff setting mechanisms and the financial obligations of the financing authority;
- Contract monitoring, enforcement and conflict resolution mechanisms;
- Risk allocation and management.

Experience from EECCA countries is reviewed and benchmarked against best practices in comparable countries. Some pragmatic recommendations derive from the analysis, which are developed in the publication. They lay the conditions for improved contractual relationships between public authorities and water service operators in EECCA.