

PUBLIC

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PUBLIC UTILITIES POLICY

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PUBLIC UTILITIES POLICY

I. BACKGROUND AND SCOPE OF APPLICATION OF THE POLICY

- 1.1 The document “Strategies, Policies, Sector Frameworks and Guidelines at the IDB” (document GN-2670-1) sets forth the commitment to develop a revised cross-sectoral policy entitled “Public Utilities Policy” (the “Policy”). Consequently, this document supersedes the Public Utilities Policy (Operational Policy OP-708) of July 1996.
- 1.2 The public utilities covered by this Policy include water and sanitation, electricity, natural gas, solid waste, and telecommunications services. This Policy spans all links in the public utilities value chain, from generation or extraction, transportation, and distribution to consumption. The Policy’s scope extends to the public- and private-sector operational financing programs (reimbursable and nonreimbursable; sovereign and non-sovereign guaranteed) of the Inter-American Development Bank (IDB) (“the Bank”) and the Multilateral Investment Fund (MIF).
- 1.3 **Consistency with safeguard policies.** The Bank will apply this Policy in conjunction with its safeguard policies, which include the Operational Policy on Indigenous Peoples (Operational Policy OP-765), the Environmental and Safeguards Compliance Policy (Operational Policy OP-703), the Policy on Involuntary Resettlement (Operational Policy OP-710), the Policy on Women in Development (Operational Policy OP-761), and the Disaster Risk Management Policy (Operational Policy OP-704).

II. OBJECTIVE

- 2.1 Recognizing the heterogeneity in public service delivery in Latin America and the Caribbean, this Policy’s objective is to guide the Bank’s actions to promote universal access to and increase the efficiency and quality of public utilities service delivery under conditions that are affordable and environmentally and socially sustainable, so they contribute to the process of socially inclusive economic development.
- 2.2 The promotion of access to and the increased efficiency and quality of public utilities will require that the Bank’s actions aim to:
 - a. **Promote access to the service by the entire population**, including the most disadvantaged communities and groups, in both urban and rural areas.
 - b. **Deliver a reliable, quality service**, ensuring that the service provided to the user meets minimum quality and reliability standards that are viable and consistent with a cost-benefit or cost-efficiency analysis, in keeping with the nature of the service and the supply conditions.

- c. **Deliver a service efficiently** in terms of supply, while seeking to deliver the service at the least possible cost.
 - d. **Create suitable incentives for service demand**, so users make use of the services in a manner consistent with their economic, financial, and environmental sustainability.
- 2.3 The scope of the sustainability of the public utilities will be promoted based on three pillars:
- a. **Financial sustainability**: ensuring that there are sufficient revenues from provision of the service to the user, with the community contributions and direct contributions from the government, to cover the efficient costs of service delivery.
 - b. **Environmental sustainability**: helping ensure that the selection, execution, operation, and maintenance of the service delivery projects comply with the Bank's environmental safeguards and contribute to the development of resilient infrastructure, considering viable alternatives to mitigate climate change.
 - c. **Social sustainability**: helping increase access to the service and providing mechanisms to consult with the community on pertinent aspects of service delivery.

III. PRINCIPLES

- 3.1 The Policy is based on the following principles that will guide the design and supervision of the Bank's operations.
- 3.2 **Supporting the countries to address basic access needs.** The expansion of access to public utilities at affordable prices is necessary in the region, especially in less developed countries and rural areas in all countries. Access to public utilities is essential to contribute to poverty reduction and promote inclusive development. The Bank will support the development of sustainable systems that use the combination of cost-efficiency and the most appropriate technology solutions, given the characteristics of the demand and the public utility, to address the access needs of the population, both urban and rural.
- 3.3 **Continual improvements in the governance of public utilities will be key for increasing efficiency in service delivery and satisfactorily protecting the interests of users.** The Policy holds that governance for decision-making in public utilities management, as well as the policy and/or regulatory framework that regulates and supervises the utilities are the primary factors determining their performance, quality, and sustainability. This requires the following:
- a. **Promoting integrity, transparency, and accountability.** Bank-financed operations will drive basic institutional arrangements so the region's countries adopt measures that promote integrity and increase transparency in the

delivery of public utilities services, in order to improve accountability and strengthen the observance of users' rights. To this end, the Bank will make greater efforts to have its operations contribute to the development of good governance systems among public and private stakeholders. Moreover, this Policy recognizes that the weakness of public statistical data and the scarcity of private statistical data are factors that often hinder adequate responses to basic questions on infrastructure investment needs, service provider performance, and rate structure and evolution. Therefore, the Bank will promote targeted transparency, considering users' information needs, the most effective way in which information should be made available, and the best channels for its distribution.

- b. **Analyzing the characteristics and impacts of subsidies.** The operation and financing of the services addressed by this Policy should efficiently recover service delivery costs through rates charged to users. However, this Policy acknowledges that, occasionally, financial sustainability can be achieved by supplementing the revenues earned through rates charged to users for the service with contributions from the community and direct government contributions. Where subsidies are granted, the Bank will promote both their transparent allocation and use, subject to frequent, effective accountability mechanisms. Such mechanisms will include: (i) identification and analysis of sources and beneficiaries of the subsidies; (ii) analysis of the distributive incidence of the subsidies; and (iii) quantification of the subsidy relative to macroeconomic indicators (for example, gross domestic product, total public sector expenditures) used by the Bank or by the level of government granting the subsidies to report on their fiscal sustainability. In cases where rate subsidies are granted, the Bank will promote their targeting toward the most vulnerable and lowest-income groups. In addition, to the extent possible, the Bank will help countries replace rate subsidies for public utilities with income transfer mechanisms that are more direct and targeted toward the lowest-income population segments.
- c. **Separating institutional roles to improve sector governance.** Experience shows that the most effective organization for the sectors to achieve this Policy's objective is the separation of the roles of policy-maker, regulator, and service provider. In this context, the sector authority retains responsibility for policy-making and planning, the public agencies determine and oversee compliance with the regulatory system, and public or private entities are assigned responsibility for providing the service. This Policy recognizes, nonetheless, that the institutional organization cannot follow a single model, but must be adapted to the specific features of each sector and country. In several of the region's countries, responsibility for policy-making, regulation, and delivery of public utilities is based at the local (provincial or municipal) level. In these cases, where it is not necessarily optimal to separate the roles of policy-making and regulation, the Bank will promote homogeneous regulation, with adequate minimum quality parameters, rate-setting principles,

supervision and control mechanisms. It will also help develop institutional mechanisms that strengthen appropriate management in the framework of local legislation.

- d. **Establishing the most appropriate sector structure given the characteristics of the service and the objectives of the Policy.** Experience in reform processes and management changes in Latin America and the Caribbean shows that good or bad performance by public utilities providers is not necessarily explained by the type of ownership (public or private), or by the sector's structure (monopoly or competitive). For that reason, and considering the heterogeneity of markets and services in the region, this Policy does not promote a single sector industrial organization for the delivery of public utilities, and emphasizes that regardless of the management model used, there must be good governance practices and a clear, predictable, stable regulatory framework that encourages efficiency and investment.
- e. **The role of economic regulation in creating incentives for efficiency, investment, and protection of users' rights.** The adoption of an effective regulatory system tailored to the specific conditions of each sector in each country is a key factor for achieving the Policy's objectives. A regulatory system should help reduce the capital cost of service providers, encourage investment, set service quality standards, and allow service providers to obtain sufficient revenues to be financially sustainable. The selection of the most appropriate institutional instrument for the specific conditions of the country and the service is of the utmost importance for the effectiveness and sustainability of the regulatory process. This instrument may take various forms, from regulation by contract to more complex methods that require the creation of a multisector regulatory body or even a specific one for each service. The probability that economic regulation will contribute to achieving the Policy's objectives increases with the degree of independence, autonomy, and transparency of the regulatory institutions and processes. The promotion of users' rights should be a core objective of the service regulation process. Thus, regulation should ensure that the efficiency gains achieved over time by the service providers are passed on to the users through rate reductions or improvements in service quality. For this to happen, it is essential to prevent the abuse of dominant market power by the provider and strictly apply the standards for quality of service. Regardless of the sector structure and institutional regulation model selected by each country, the Bank will provide assistance in developing information systems that show policy-makers and users the structure and cost and rate levels at all stages of service production.
- f. **Creating the proper conditions so private participation in public utilities service delivery is a viable option.** This Policy recognizes that competition has the potential to increase productive efficiency and quality of service. In markets where production technology does not exhibit characteristics specific to natural monopolies, market competition can be generated by allowing

several companies to offer services simultaneously. When the markets are natural monopolies, competition for market can produce the same results as competition in the market, as long as the process of selection and regulation of the company providing the service is open and effective. The Policy also recognizes that private participation (in any of its manifestations, including management contracts, concessions, or mixed-ownership enterprises) is a key tool for closing gaps in the quantity and quality of utilities in the region. Attracting private participation to the services covered under this Policy and maximizing its impact on efficiency gains in service management depends on the existence of a macroeconomic context that favors investment and credit, a clear, stable institutional and regulatory framework, and economic conditions that reduce capital cost and allow for reasonable returns on investment. In those cases where the countries consider that competition and implementation of public-private partnerships are suitable mechanisms for promoting the expansion of the supply and enhancing the quality and efficiency of public utilities services, the Bank will provide assistance in strengthening the institutional and legal framework and in developing rules and mechanisms that encourage the participation of enterprises under equal conditions.

- g. **Strengthening the management of infrastructure used for public utilities service delivery.** Increasing the supply of infrastructure is not always the most efficient solution in response to growing demand for public utilities. Diagnostics often encourage building more infrastructure over promoting optimal use and management of existing assets, in order to increase the supply and quality of public utilities services, thus avoiding sub-optimal investments. The most pertinent spheres of action for optimizing infrastructure management are: (i) encouraging efficiency in business management; (ii) developing and implementing appropriate, stable asset maintenance policies; and (iii) optimizing the use of the infrastructure through incentives for demand. Policies to drive demand through the setting of standards or the establishment of price incentives (including congestion charges and peak and off-peak rates) have the potential to change consumption patterns while increasing the availability of infrastructure services. Optimization of infrastructure use through price mechanisms not only allows cost savings, but can also contribute to environmental sustainability by creating incentives to conserve, and therefore reduce emissions and adverse impacts on ecosystems. When establishing price incentives and changing rates, it is highly advisable to rigorously analyze their distributive incidence among the various types of users, in order to report on possible impacts on social inclusion.
- 3.4 **Promoting innovation to foster efficiency, access, and environmental sustainability.** Technological advances make it increasingly possible to design targeted solutions to meet the demand for infrastructure services. Photovoltaic power generation, microhydroelectric generators, and waste separation plants for recycling are examples where technology fulfills the dual role of increasing the supply of services and contributing to environmental sustainability through the

development of a lower-emissions offering. The adoption of the latest technologies can also help reduce service delivery costs, for example, through technical and nontechnical loss detection in water and power distribution. Moreover, technological innovations such as smart meters, have the potential to reduce utilities consumption during periods of high demand. This Policy highlights the role of technology for increasing access with cost-effective solutions, reducing maintenance costs, and managing consumption, while avoiding unnecessary investments in increased capacity. The Policy recognizes that the Bank will help disseminate information on the adoption, financing, and systems for management of the most appropriate technology solutions for each particular combination of public utility and demand characteristics.

IV. CONDITIONS

- 4.1 To achieve this Policy's objective, the Bank will verify that all its operations meet conditions of financial sustainability and economic evaluation.

1. Financial sustainability

- 4.2 For each operation, it will be verified that the relevant service will generate or receive sufficient funds to meet its financial commitments and cover the operating and maintenance costs of the systems related to the operation.

- 4.3 When a Bank operation involves contributions of budgetary funds to subsidize the provision of a public utility service, it will be verified that:

- a. the budgetary allocation of such contributions is transparent; and
- b. its purpose corresponds with one of the following objectives:
 - i. Expansion of capacity to provide greater access
 - ii. Increase in the quality of the existing services
 - iii. Improvement in process administration and adoption of technology for the services to contribute to climate change mitigation or to the management of natural disaster risks.

- 4.4 When the budgetary funds represent rate subsidies, it will be confirmed that progress is made on the design and implementation of the subsidy targeting instruments that grant priority to the most vulnerable and lowest-income groups.

2. Economic evaluation

- 4.5 Public utilities projects will be economically viable in accordance with the cost-benefit and cost-effectiveness evaluation methodologies used and accepted by the Bank.

V. BANK PARTICIPATION

- 5.1 The Policy is designed to address the main challenges faced in the delivery of public utilities services in the region: (i) the need to expand services in pursuit of

universal access; (ii) addressing the growth in demand for public utilities; (iii) generating incentives to increase efficiency in public utility service delivery; (iv) ongoing strengthening of public utilities' planning, management, and supervision; (v) incorporating the environmental dimension in public utilities delivery, including the adoption of actions to adapt and mitigate climate change; (vi) strengthening the institutional and legal framework so the services are economically and financially viable and sustainable; and (vii) creating the right conditions to attract and encourage participation by diverse financing sources, including the financial and capital markets, private investment funds, development agencies, and concessional funds, to leverage the Bank's financing resources and thus help close existing gaps in the quantity and quality of public utilities in the region.

- 5.2 To meet its objective, the Bank must consider how its operations are consistent with this Policy. Recognizing that the achievement of this Policy's objective may require timeframes longer than an operation's execution period, the Bank must assess the benefits of programmatic interventions and the use of technical assistance while considering the gradual nature of change and the extended terms required by institutional strengthening and service improvement processes.
- 5.3 The Bank's assistance may be required to improve the performance of public utilities in cases where the conditions established in this Policy are partially met. When the decision is made to process operations under such circumstances, Management will monitor progress toward meeting the conditions set in Section IV of this Policy using indicators formulated in accordance with its objective and principles.