

**RELATIONS BETWEEN THE EU DEVELOPMENT POLICIES AND THE
ONGOING EU POSITION IN THE WTO/GATS NEGOTIATIONS ON THE
LIBERALISATION OF WATER SERVICES**

**EXECUTIVE SUMMARY
of Final Report**

**Ian Gillson, Tom Slaymaker, Sven Grimm and Peter Newborne
ODI, London, UK**

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The research project on *Relations between the EU Development Policies and the ongoing EU position in the WTO/GATS negotiations on the liberalisation of water services* is one of 23 projects funded by EC-PREP, a programme of research sponsored by the UK Department for International Development (DFID). All EC-PREP research studies relate to one or more of the six focal areas of the European Commission's (EC's) development policy in the context of their link to poverty eradication.

EC-PREP produces findings and policy recommendations which aim to contribute to improving the effectiveness of the EC's development assistance. For more information about EC-PREP and any of the other research studies produced under the programme, please visit the website www.ec-prep.org.

The project comprises case studies of Mexico, South Africa and Senegal carried out by the Overseas Development Institute-ODI, based on a review of available literature and key informant interviews held in the three countries in the last quarter of 2004. Interviews were held with a cross-section of stakeholders including government, private sector, NGO representatives and academics.

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It should be noted that the views expressed are those of the authors alone and do not necessarily reflect those of the EC or DFID.

A full Report (96 pages) and separate report of the Mexico case study accompanies this Executive Summary.

The picture in brief

The grave deficiencies in the current reach of water and sanitation supplies in developing countries have been documented: an estimated 1.1 billion people do not have access to clean drinking water and 2.4 billion people – around 40 percent of the world’s population – lack safe and hygienic sanitation. Most of the world’s unserved population live in Asia but as a proportion of the population living in each region, Africa has the lowest levels of access (only 34% of the population have household connections). Access to clean water and improved sanitation is being hindered by problems of growing demand (due to population growth, rapid urbanisation, agricultural irrigation and industrial use), changes in long-term resource availability (arising from climate change and over-abstraction) and rising costs of resource management and service provision (higher volumes of wastewater are aggravating purification efforts).

Given the fundamental importance of access to water for human health, over 180 countries have endorsed the Millennium Development Goals (MDGs), including the water targets to halve by 2015 the proportion of people without sustainable access to safe drinking water, while also committing to improve access to basic sanitation.

Differences persist over how best to improve the provision of water services in developing countries. There are those who argue that water supply and sanitation (WSS) services have been mismanaged by the public sector, and that liberalisation is needed to allow both domestic and foreign private sector participation and financing. Others are concerned that profit motives within short-term business cycles may not be appropriate in the provision of WSS which they see as being predominantly public goods, and suggest that governments redouble their efforts to improve access for the poor, supported by Official Development Assistance.

The European Union (EU) has adopted positions on both liberalisation and development in relation to water services.

First, in 2002, it made requests¹ to 72 countries to make liberalisation commitments under the General Agreement on Trade in Services (GATS). It is on the initial 2002 requests that this study has focused.

A key element of the EU’s negotiating position is reclassification of ‘environmental services’ under which ‘water for human use and waste water management’ would become a new GATS sub-sector. The EU is requesting that countries make liberalisation commitments on market access and national treatment for the ‘water distribution’ sub-sector in the current GATS negotiating round. The market access principle, for example, prohibits limitations in the participation of foreign service providers (and foreign direct investment) unless specifically listed as a limitation in a country’s schedule of commitments, while under the national treatment principle, governments can elect either to treat foreign services and service suppliers in the same way as domestic services and service suppliers, or include limitations in their commitments to favour the latter.

¹ The EC and its Member States has made, subsequently in January 2005, *revised* requests in which it modified the approach. In comparison with the initial requests, the revised requests include a number of clarifications and a reduction of the scope of the requests, especially for LDCs. The revised requests place more focus on advisory (consulting) services where commitments are notably requested for cross-border supply. In the same vein, the requests under other environmental services are restricted to environmental impact assessment and environmental risk analysis, two key activities for sustainable development. For infrastructure services (water and solid/hazardous waste) the request makes a clearer distinction between services supplied directly to business (notably industrial customers), where more ambitious commitments are sought, and the traditional public services (notably municipal services), where the request is more focussed.

Meanwhile, current EU development policies on water are set out in the EU Water Initiative (EU WI) which aims to align existing EU spending on water-related development in developing countries by concerted action of different parts of the Commission. A section on the EU WI is included later in this Summary. Its key goal is expressed to be the EU's commitment to the MDGs, particularly the targets on WSS. In other words, as contemplated by the EU WI, a key aim of EU development policies is "pro-poor" impact.

The question arises: how are **the 'pro-trade' and 'pro-development' objectives of EU policy in relation to the water sector consistent and coherent (if at all)?**

If pro-trade and pro-development objectives *are* to be compatible and convergent in relation to WSS, it must be possible at a national level to liberalise the market according to GATS principles and to regulate so as to secure (poor) citizens' access. But is this actually the case?

GATS principles are detailed and evolving - some rules are still under discussion - with uncertainties as to how they will be interpreted and applied. At the same time, modalities of regulation in the water sector are also in process of evolution as public authorities adapt to a supervisory role over private service providers. So, how does this GATS - development relationship operate in practice?

To shed light on this question, the European Commission (DG DEV) commissioned this study which maps the pro-trade versus pro-development interaction in three countries: Senegal, Mexico and South Africa, all of which were included in the EU's GATS requests for liberalisation of WSS and where existing markets offer opportunity for analysis in 'live' situations.

The following is a summary of the findings (to accompany the full report of the study).

Financing water and sanitation services

The pro-trade "*versus*" pro-development debate is reflected in relation to the challenge of how to remedy the deficiencies in water services in developing countries, including filling gaps in financing.

The high construction and installation costs of water infrastructure (such as reservoirs and pipeline networks) and the frequently complex demands that they have to meet, as well as potentially costly quality controls, mean that substantial investment in water services is necessary if the service gaps in developing countries are to be filled.

On the supply side, water services are suffering from the cumulative effects of years of under-investment. Currently, according to available figures, most investments in the water sector come from the domestic public sector (65-70 percent), followed by international donors (10-15 percent), international private companies (10-15 percent – this is discussed below) and the domestic private sector (5 percent). A key issue is that international private investment and commercial bank lending have suffered from a general decline in private flows since their peak in 1997 following the Asian financial crisis, volatility in the currency markets and the knock-on effects of the internet bubble. Public funding, therefore, remains important, but it is subject to the fiscal position of developing countries whilst international aid for water and sanitation has fallen (US\$3.1 billion per year in 1999-2001 compared with US\$3.5 billion in 1996-98).

Estimates of the funds required for future investment in water services vary. Over and above the existing annual expenditure of US\$70-80 billion, the Global Water Partnership have suggested that US\$180 billion (for all water uses including agriculture) is required annually to overcome under-provision in developing countries, of which US\$30 billion is needed for drinking water and sanitation alone. Vision 21, a document produced by the Water Supply

and Sanitation Collaborative Council, suggests an additional US\$9 billion is required each year, on the basis of population projections.

These factors have led some governments and donors to encourage international private investment in the water sector in developing countries, with a view to maintaining and improving quality and quantity of the basic service to growing populations. On the demand side, the principle of managing water as an economic good is increasingly being promoted in order to ration its use: if water is assigned a price, as opposed to being provided free of charge, then information can be passed to consumers about its value and scarcity.

The pro-trade view argues that, through opening markets to foreign firm rivalry, regulatory authorities can play foreign and domestic investors against each other which could result in better licensing concessions from a public welfare perspective. One way to do this – for some the most credible way - would be under GATS, which has been conceived as a basis for World Trade Organisation (WTO) members to liberalise their services trade. GATS is designed to regulate all trade in services, and applies to all ways (or modes) in which services can be provided. Another way of proceeding would be for governments to autonomously establish domestic regimes and regulation, for allowing (or limiting) foreign investors.

There has, however, been little systematic consideration of how the inclusion of water services under the GATS might affect the achievement of development goals in the water sector, including the MDGs of extending and improving access to water services of the world's poor people.

On the one hand, proponents of the effort to liberalise water services under the GATS claim that it would bring about predictability for foreign investors, thereby increasing investment in water infrastructure.

On the other hand, critics of this approach argue that, unlike other services, public benefits (water is essential for human health and welfare) mean water management should remain under the authority of government utilities. Further, the GATS is a threat to publicly-provided services in that it will force governments to privatise and allow competition in public services, beyond what is desirable for development, and particularly for development of water services in poorer areas.

EU Water Initiative

The EU Water Initiative (EU WI) was launched at the World Summit on Sustainable Development (WSSD) in Johannesburg in September 2002. It has a strong regional focus with modules in Africa, Eastern Europe, Asia, the Mediterranean and Latin America.

As alluded above, the key goal of the EU WI is expressed to be the EU's commitment to the the MDG targets on WSS - within the context of an integrated approach to water resources management (IWRM). The WSS targets aim to *reduce by half the proportion of people without sustainable access to safe drinking water by 2015 and halve by 2015 the proportion of people without access to basic sanitation.*²

In other words, as contemplated by the EU WI, a key goal, in the medium/long term, of the 'development policies of the EU' is the provision of water services to populations in low and middle-income countries who do not have adequate access to them.

The EC noted in 2003 (European Commission (2003c) that progress towards achieving the MDG poverty reduction targets, as embraced by the EU WI, was dependent on pursuit of the

² The sanitation target was added by the WSSD in 2002, together with a target to develop integrated water resources management and water-efficiency plans by 2005.

five key objectives including the following: promotion of improved water governance, which should include multi-stakeholder dialogue and coordination; and identification of additional financial resources and mechanisms to ensure sustainable financing.

“Water governance” is a broad concept which the EC noted, in the same document, may include ‘political and sectoral reform as necessary’. Clearly one type of sectoral reform which may be made in the water sector *inter alia* is a switch from public to private provision of water services (or a combination of the two) and regulation of these activities.

Private sector involvement was mentioned in an EC statement on the EU WI, that: ‘The evidence suggests that partnerships between public, private and civil society actors are the most adequate way to ensure improved efficiency and effectiveness of water management’ as long as they are ‘equitable, transparent, safeguard consumers’ and investors’ interests...’ (European Commission, 2003c, page 22, emphasis added).

The potential of Private Sector Participation (PSP)

As mentioned above, the need for substantial investment in water infrastructure and services in developing countries is generally recognised. But there has been a failure to identify under what conditions developing countries could or should transfer ownership (or operation) of water services to private interests in exchange for financing. The debate about delivering water services has tended to split into two broad camps.

On the one hand, some argue that governments must redouble efforts, supported by Official Development Assistance, to address the funding gaps. Water services, it is argued, have public benefits that should be excluded from private sector profit motives operating on short-term business cycles. It is noted that foreign private investors and water companies are choosing only a very few developing countries – notably China and some other high-growth Asian countries – in which to invest and have exited most of Latin America. Against this background, the fear is of a regulatory race-to-the bottom in order to attract investment.

On the other hand, there are those who argue that water services are mismanaged by the public sector, and that private sector participation (PSP) is needed. Proponents of PSP list a range of shortcomings associated with public utilities including: problems in collecting bills (for cost-recovery purposes); failure to adequately plough-back revenue for infrastructure improvements; susceptibility to corruption and political interference; and low levels of innovation in technologies and management systems. The international private sector is, in contrast, credited with offering benefits such as specialised skills, greater efficiency in resource management and services delivery, and more direct access to finance for new investments.

It is unlikely that the debate over public versus private provision of water services will be easily resolved. It is also unclear that it needs to be for three reasons.

First, in debating whether water services should be provided by the public sector or privately (including collaborative arrangements), attempts have been made to argue that given the innate characteristics of the sector either one or the other form of provision is inherently better. However, this perspective lumps together very diverse actors and agencies in both the private sector (e.g. informal vendors and multinational corporations) and the public sector (e.g. public utilities, regulators, local authorities and Government ministries).

Second, it may well be possible for PSP to promote efficiency and increase the financial resources for improving water services. However, it can also direct finance to urban centres that are already comparatively well-served (having implications for universal access), adversely affect equity (especially when prices rise) and create new regulatory problems (since water markets are typically monopolistic, public authorities must develop strategies to

regulate water tariffs but developing countries often have weak regulatory, monitoring and enforcement powers). Much depends on the way PSP is developed and the local context.

Third, a key element of the local context will be its characteristics from an investment perspective. A recent EU-sponsored study has raised questions as to the circumstances in which PSP actually contributes to the financial relief of the public sector. The PRINWASS survey of capital investment made by the private water companies in 17 cities in nine countries in Africa, Europe and Latin America (including 'mature' cases of 10-15 years of PSP, 'intermediate' cases of 5-9 years of PSP and one 'incipient' case of 1 year of PSP only) reported 'a consistent pattern' of very low or zero contributions of fresh capital from the private operator's own capital. Revenues had constituted by far the major source of funding supplemented by loans and state subsidies.

In this connection it should be noted that, currently at least, large private operators have a small share of the water market in developing countries. Only 5 percent of the world's water is actually distributed by the private sector, largely in developed countries and even when the private sector has assumed a role this usually takes the form of public-private partnerships (PPP). Small-scale independent water providers operating small pipe networks, distribution at kiosk and water tankers currently play a major role in developing countries. The central question therefore is not whether privatisation is, or is not, good in the abstract, but rather under what conditions the transfer of ownership or operation from public to private entities may guarantee the protection of health, welfare and livelihood benefits associated with water services?

GATS and water

At the multilateral level, the GATS governs some measures affecting trade in services and serves as a basis for WTO Members to progressively liberalise their services trade. The GATS regulates all trade in services (except for those which are supplied in the 'exercise of governmental authority' and the greater part of the air transport sector), and applies to all types of domestic regulation at all levels of government and covers all modes of supply, namely:

- Cross border supply (mode 1): services supplied across borders from the territory of one Member into the territory of another e.g. software on a floppy disk.
- Consumption abroad (mode 2): services supplied in the territory of one Member to the consumers of another e.g. tourism.
- Commercial presence (mode 3): services supplied through foreign-owned companies.
- Temporary movement of natural persons (mode 4): services supplied by nationals of one Member in the territory of another e.g. employees working abroad on temporary contracts.

The GATS does not define services but lists their supply aspects, which includes production, distribution, marketing, sales and delivery. A sectoral classification of services (MTN.GNS/W/120) was established in the framework of the Uruguay Round, inspired by the UN Central Product Classification. The use of this sectoral classification is not mandatory, but most Members follow it to schedule their commitments³. The GATS covers 161 service activities across 12 classified sectors: business, communications, construction, distribution, education, environmental, financial, health, tourism, recreational, transport and other.

³ It is recognised that there are a number of sectors in which the GATS W/120 classification is problematic, so there has been discussion on how to improve the classification in those sectors.

Water-related services are listed as sub-sectors under environmental services which are currently defined as including the following activities: sewage services, sanitation services, refuse disposal services, cleaning of exhaust gases, noise abatement services, nature and landscape protection services. This definition of environmental services has been criticised for being too narrow i.e. water distribution services are not explicitly included. Consequently, GATS commitments for water-related activities have only been made for sewage and sanitation services.

In its application, the GATS distinguishes between general obligations which are those measures a country agrees to apply to all its services sectors and sector-specific commitments which apply only on specified sectors, as offered by each WTO Member.

General obligations

For all sectors, the most-favoured-nation (MFN) principle (Article II) obliges non-discrimination between foreign services providers. However, the GATS allows for exceptions to the MFN principle by virtue of two provisions. First, when the GATS first entered into being in 1995, Members were allowed a single opportunity to list exemptions from the MFN principle. Most were intended to be permanent exclusions, but are subject to negotiation in the current round. Second, Article V authorises services trade liberalisation in the context of regional integration agreements if they have ‘substantial’ coverage in terms of services sectors, volume of services trade and modes of supply and provide for national treatment among services providers in the countries party to the agreement eliminating ‘substantially’ all discrimination.

Article III contains general obligations on transparency. Under the GATS, Members are obliged to publish all domestic regulatory measures affecting services trade and establish enquiry points to provide this information.

Finally, all WTO Members must participate in rounds of GATS negotiations with the aim of achieving higher levels of services trade liberalisation (Article XIX). There are also provisions for holding negotiations to develop GATS rules relating to emergency safeguard measures (Article X), government procurement (Article XIII) and subsidies (Article XV).

Sector-specific commitments

All other GATS commitments apply to the extent that each Member has accepted them on a sector-by-sector basis. A Member can choose to make commitments (by mode of supply) to open its market to foreign service suppliers (market access – Article XVI) and / or guarantee non-discriminatory treatment between foreign and domestic suppliers (national treatment – Article XVII). Sector-specific commitments are listed in ‘schedules of specific commitments’.

Members have complete flexibility (at least in principle, subject to any pressure by trading partners which may be exerted in practice) to determine the sector coverage and substantive content of schedules. There is no minimum for the number of sectors to be included (although all Members have committed at least one part of a sector) and while some countries have scheduled all major services sectors, others have listed only a limited number. Members can also make market access and national treatment commitments *across* sectors in what are known as horizontal schedules of commitments.

For each sector listed in a Member’s schedule, there are measures inconsistent with market access (listed in Article XVI) which the country cannot maintain or adopt, unless listed as a limitation in its schedule of specific commitments:

- 1) Limits on the number of services suppliers;
- 2) Limits on the total value of services transactions or assets;

- 3) Limits on the total number of services operations or the total quantity of the services output;
- 4) Limits on the total number of natural persons that may be employed in a particular sector;
- 5) Limits on specific types of legal entity through which services can be supplied;
- 6) Limits on foreign equity participation.

Similarly, national treatment under the GATS applies only to those services sectors inscribed in a Member's schedule of specific commitments. Restrictions can be imposed provided they are, again, listed. Unlike the disciplines for market access, Article XVII provides no exhaustive list of measures inconsistent with national treatment but it makes clear that all *de jure* and *de facto* measures that favour domestic services suppliers must be listed if they are to be maintained.

Within a Member's schedules of specific commitments:

- An entry of 'none' indicates that a Member is bound to not having or introducing any measures that restrict market access or national treatment for a sector and mode of supply (but any limitations set out in the horizontal schedule still apply).
- The term 'unbound' indicates that no commitment has been made and the Member is free to introduce market access and national treatment limitations.
- 'unbound*' appears for sectors in which a particular mode of supply is not technically feasible e.g. cross-border supply of construction services.
- All other entries which include commitments with limitations are known as 'partial commitments'. A Member is bound to not introduce any additional measures that restrict market access or national treatment.

For sectors where WTO Members have made specific commitments, Articles VI and VII of the GATS deal with domestic regulation and recognition, respectively. Since negotiated commitments on market access and national treatment could be offset by restrictive domestic regulations these rules aim to ensure a predictable regulatory environment. Although disciplines on domestic regulation are still being developed in the GATS, measures affecting services trade must be administered 'reasonably', 'objectively' and 'impartially' and should not constitute 'unnecessary' barriers to trade.

The current pattern of sector-specific commitments⁴

In terms of the number of sectors each Member has included in its specific schedule of commitments, about one-third of Members have scheduled fewer than 20 of the 160 sub-sectors specified in the GATS classification list, one-third have committed between 21 and 60 sub-sectors and the remaining Members have included between 61 and 130 sub-sectors. The last group includes virtually all developed countries but also some developing and Least Developed Countries (Gambia, Lesotho and Sierra Leone). The services most frequently included in schedules of commitments are those sectors traditionally considered to carry low levels of restrictions (tourism) but also core 'productive infrastructure' services such as business, financial and telecommunications services which benefit the wider economy.

⁴ NB: The information supplied is at the time of the carrying out the research for this report, i.e. in November/December 2004.

The fewest commitments have been made in social sectors such as education, health, and water services (sewage and sanitation). Only 34 out of 147 WTO Members have made commitments for their sewage and sanitation services under the GATS. This reflects the wishes of many governments to retain policy discretion in areas which are often considered to be core public sector responsibilities. The three case studies undertaken by this project serve to throw light on why (see below).

Negotiations under GATS 2000 and the Doha Round

Article XIX of the GATS sets out objectives for future negotiations on services trade. As a result of the Uruguay Round, WTO Members agreed to resume negotiations on all services by 1 January 2000. On the basis of this, and reiterated by the Doha Declaration, all WTO Members were committed to start a new round of negotiations – the GATS 2000 negotiations – with a view to ‘achieving a progressively higher level of liberalisation’.

Although the basic rules for the liberalisation of services trade were agreed in the GATS during the Uruguay Round, a number of issues remained unresolved and were left for the GATS 2000 negotiations. First, while GATS in principle covers all sectors, the number of commitments remains limited both in terms of the number and depth across sectors and modes of supply. Second, GATS disciplines for domestic regulation, safeguards, subsidies and government procurement have yet to be developed.

Under the GATS negotiating process, individual countries make requests to other countries for them to make market access and national treatment commitments in specified sectors. Countries then make offers for liberalisation based on the requests that they have received. The request process is bilateral and Members normally submit requests in the form of a letter asking a country to make commitments for a sector or to remove certain market access or national treatment limitations from a sector which has already been scheduled.

As to the EU’s negotiating position, core to this is the reclassification of environmental services. Under the proposed classification, designed by the EC to improve the current listing of environmental services⁵ ‘water for human use and waste water management’ would become a new GATS sub-sector. The EU requested in 2002 that 72 countries make commitments to open up their water distribution sub-sectors in the current negotiating round.

Offers can be used to respond to requests or are made in sectors where a country would like to volunteer autonomous liberalisation. Offers take the form of a draft schedule of specific commitments. Unlike requests, offers are distributed to all Members, via the WTO Secretariat, and are subject to multilateral negotiation. Offers can generate more requests as part of the negotiation process although not all countries may make requests or submit offers.

In contrast to the requests made to its trading partners, the EU’s conditional offer includes sanitation services, but excludes water for human consumption. Canada, Switzerland, and the US also excluded drinking water services from their GATS 2000 offers.

The impact of GATS on the water sector

The EU’s proposal to reclassify environmental service to include water distribution has led to a variety of claims which describe the GATS as being both a threat to publicly-provided water services and inconsistent with the EU’s development policies: that it puts in danger the assurance of basic public services by forcing governments to privatise and allow competition, and obliging them to open up to foreign trade and investment. Different aspects of this issue are now summarised.

⁵ By “providing more modern and precise definitions and a more user-friendly list of sub-sectors according to the environmental medium on the basis of work done within the OECD/Eurostat manual”.

Limiting foreign capital participation

A conclusion from the literature on privatisation is that welfare gains accrue from increased competition within a market rather than from a mere shift in ownership from the public to the private sector. Foreign investment may also relax a domestic capital constraint and help to improve productivity in the sector. In services trade, however, restrictions on new entry and on the participation of foreign capital are common.

In the GATS context, WTO Members have often conceded increased market access by allowing foreign ownership of domestic firms or (limited) new entry. For water services, however, there may be strong economic reasons to limit the number of suppliers operating domestically. If natural monopolies are present, entry restrictions may be justified by the existence of economies of scale stemming from high fixed costs of networks. Restrictions on entry may also be justified on policy grounds. First, market access restrictions may be designed so that existing suppliers are only gradually exposed to competition for infant-industry type reasons. Second, monopoly rents are sometimes seen as a means of helping firms secure universal service obligations. Third, rents are often believed to be necessary to finance new investments in infrastructure. Finally, governments may seek to raise revenue by auctioning monopoly rights.

It is difficult to find a convincing economic rationale why these limitations should focus on restricting only foreign ownership. Since the incentives for promoting efficiency and increasing finance are often related to an owner's share of the profits, ownership limitations are bound to reduce these incentives and adversely affect the sector's performance.

However, in practice countries are willing to discount this for a number of reasons. First, if there are monopoly rents, limitations on foreign ownership may be designed to balance profit appropriation aspects of foreign investment (although this argument ignores the possibility that profits of foreign firms can be taxed). Second, foreign service providers can be encouraged to form joint ventures with domestic firms so that the latter can benefit from technology transfer and the sharing of management skills. Finally, governments may be reluctant to allow foreign ownership of essential services, like water.

Social and political sensitivities

Water services are recognised as having important positive externalities associated with human health and, because of these, PSP in the sector is often surrounded by considerable social and political sensitivities.

GATS rules do not, however, dictate any specific role for the public and private sectors: countries are free in principle to decide those sectors to be reserved for parastatals. In addition, they remain free to decide whether or not to open such sectors to foreign competition and to make binding commitments in their GATS schedules. But while it is true that there is nothing that strictly compels WTO members to open services to negotiation, there is clearly an indirect link between competition-enhancing policies that are bound by the GATS and the likelihood that foreigners will invest.

The participation of foreign companies in the provision of water services has raised an additional controversy – the fear that a national asset would be vulnerable under foreign influence and control. For example, under the national Water Law in Mexico water is the property of the nation: a public resource. While technically GATS only deals with access to services markets, and does not touch on the issue of access to resources, it may be difficult to demarcate these effectively since it is possible that once market access is granted, companies will insist on access to water resources.

An important element in the debate is that services supplied in the exercise of governmental authority are excluded from the scope of the GATS (Article I:3). In the case of water services,

the question arises as to the extent to which water services provided by the private sector operating under concessions could be excluded as essential government services. The degree of government funding varies across countries, depending on social and political preferences over the role of the state in their provision.

A related issue is whether the right to participate in the bidding process for concession contracts amounts to granting market access or if these would fall within the remit of government procurement (and so be excluded). This issue is potentially significant since countries are often reluctant to reopen competitive bidding processes when a contract expires. In both Mexico and Senegal, for example, water concessions have been renewed with existing incumbents without recourse to competitive bidding processes. Such decisions are often taken when there is overall satisfaction with the performance of existing service providers, short durations of renewals and a desire to reduce transaction costs.

Domestic regulatory autonomy

Central to the anti-GATS critique are perceived threats to a country's sovereign right to regulate water services, or the alleged transfer of regulatory autonomy from national governments to the WTO. The provision of basic services often involves governments balancing economic with social aims beyond issues of efficiency and profitability. Many countries' water services are highly regulated in order to protect consumers and to achieve universal service objectives.

Although domestic regulatory autonomy is required to enable domestic rules to respond to conditions within a country, there may be times when such rules are trade-distorting, either unintentionally or as disguised protectionism. A problem in the GATS concerns those rules dealing with the centrally important issue of domestic regulation and its effect on market access.

On the one hand, these rules rank among the weakest and most undeveloped elements. The specific obligations concerning domestic regulation in the GATS framework aim at requiring Members to regulate those services sectors in which they have made commitments in a 'reasonable', 'objective' and 'impartial' manner. These terms, however, are not clearly defined under Article VI of the GATS and much will depend on future discussions. The reference to 'necessary' disciplines has promoted concern that WTO panels would interpret this as 'least trade restrictive'.

On the other hand, regulatory precaution is reflected in the general provisions of the GATS, which uphold the fundamental right of a government to choose how it wishes to regulate in order to pursue national policy objectives. Moreover, only for those sectors, sub-sectors and modes of supply where a WTO Member agrees to schedule liberalisation commitments is the country obliged to refrain from making its regulatory regime more restrictive in the future. In scheduling commitments, WTO Members may also opt, at their discretion, to schedule limitations. Each one of these decisions remains the sovereign right of individual countries.

Regulatory and negotiating capacity

In practice, the lesson from PSP is that more, not less, regulation is needed to ensure that markets function efficiently. A key question therefore surrounds the capacity of developing country governments to assess their options in relation to GATS and the potential costs and benefits of making binding commitments. The challenge lies in identifying appropriate models of regulation which can be adapted to the resource and capacity constraints of developing country contexts. The success of PSP, both foreign and domestic, in increasing efficiency, quality and service in the water sector depends significantly on the adequacy of the local policy environment and the capacity of (often decentralised) authorities to implement new policy guidelines and assume new roles and responsibilities, including partnering with and regulating the private sector. However, many developing countries do not yet possess the

regulatory capacity to fulfil their basic obligations (e.g. universal access provision) let alone to monitor and regulate foreign private providers. Sequencing of liberalisation is vital: public authorities need to ensure that adequate regulation is in place before opening up water services to PSP, including to foreign access (under the GATS).

There are also capacity issues (for all sectors, not just water) related to the ability of developing countries to negotiate GATS commitments effectively with other WTO Members. In issuing requests and offers, coordination problems between the private sector, sectoral and trade ministries and between national governments and trade delegations in Geneva are commonly reported.

For developing countries where the capacity to negotiate GATS commitments is limited, and where the European Commission is advising trade ministries on types of market access, national treatment and regulation that it would consider acceptable as offers in response to its GATS requests, a risk of a possible conflict of interest arises. The nature of the conflict is that the same body, the EC, is providing technical assistance to assist a given developing country in order for that country to determine its position in the GATS negotiations whilst, at the same time, the EC is looking to further the EU's offensive trade interests in those negotiations.

In this context, the Commission recognises the desirability of making available technical assistance through third parties to support capacity building in relation to GATS where this is required. This is what DG Trade is doing, within the limits of its resources. It is clearly important that such disinterested methods should be used by the European Commission with the impartiality of that support being evident.

Irreversibility

Related to domestic regulatory autonomy is the concern that services commitments are bound (locked in) once made. An official modification procedure (Article XXI) exists but, to date, only the EU has used this (to make adjustments following its enlargement in 2004). Countries can also reverse GATS commitments and close sectors to liberalisation in the future, but to do so they must provide compensation to any trading partners that are adversely affected.

This could pose a problem where a public water authority, in one stage of placing concessions for PSP, delegates functions to the foreign private sector which in a subsequent stage of placing PSP contracts chooses to shift some functions back to the sphere of domestic private sector or public responsibility. If a GATS commitment were to be made in the water sector, with no specific limitations stipulating the freedom to reduce the role of the (foreign) private sector, then demands could be made for compensation. In South Africa, for example, the process of sector reform is very much ongoing and the appropriate role of PSP in relation to social and developmental policy objectives remains undecided. There are fears that GATS might restrict the policymaking autonomy of national government, or disenfranchise local government by binding them into a particular set of policy choices.

Conversely, irreversibility could be viewed as the main benefit of the GATS since regulatory certainty would arguably induce greater foreign participation into water services, which is crucial if current deficiencies in the sector are to be overcome through improvements in efficiency and management while increasing finance for investment. There is, however, uncertainty as to whether these perceived benefits would be realised. Although difficult to determine *ex ante* (there have been no commitments for water distribution services since they are not included as a GATS sub-sector), initial evidence from PSP which has happened outside the GATS framework suggest that the investment gains risk being overstated.

In particular, as noted above in relation to the PRINWASS study, earlier projected levels of private investment in the water sector have proved overly optimistic. Before 1990 there were very few large private initiatives in water services. Private investment accelerated sharply in

the early 1990s and peaked in 1997, after which it started to decline due to the Asian financial crisis (which caused both a loss in investor confidence and currency volatility) and also because private providers of water services began to realise that the sector was more complex and less profitable than originally anticipated. Private operations in many local, municipal environments were fraught with political problems, lacked implementation capacity and had restricted ability to impose tariffs. Many of the facilities in the most attractive locations were either privatised during the 1990s or have since shown few signs of allowing PSP.

In this connection, one response taken by international water companies in the face of political and economic risk is to treat their in-country investments as 'non-recourse' project financings whereby, once a local corporate vehicle has been established in the country in question by the foreign parent company (with such working capital as is necessary), the former is expected to make good of the contracts/concessions it is granted without recourse to the parent. The effect of this is that, although the creation of, or participation in, the local company may be accompanied by an initial injection of capital, thereafter there is no commitment by the foreign parent to invest. This is an important detail when the implications of working with foreign companies are being considered. In the absence of a parent company guarantee, the weight of the international company may only partially be brought into play.

Subsidies

One of the allegations most often raised by critics of the GATS concerns the presumption that it forces governments to grant domestic subsidies to all firms (including foreign) on a non-discriminatory basis. There are also concerns that in key social sectors, such as water, the GATS might constrain policymakers in providing consumer subsidies. Water pricing subsidies and social tariffs are important for the provision of water services in many developing countries. A good example is South Africa's policy commitment to provide 'Free Basic Water'

Under the GATS, however, trade in services is not yet subject to specific subsidy rules: Article XV merely provides a commitment to negotiate specific disciplines later. The GATS does not define the term 'subsidy', but the GATT defines one as arising when a government or other public body confers a financial benefit on a specific producer or group of producers i.e. it excludes consumer subsidies.

It is unlikely that the development of any rules on subsidies under the GATS would constrain their use in the water sector. First, within the GATS subsidies are considered as 'measures' for which MFN obligations apply and national treatment is applicable only to the extent that a GATS Member has listed a sector in its specific schedule of commitments. Most WTO Members have included limitations on national treatment that apply to all subsidies, while others (Canada, EU, Japan and US) have done so with respect to specific modes of supply and specific services sectors. Second, guidance on the subsidies issue can be taken from the WTO's Agreement on Subsidies and Countervailing Measures (SCM). The WTO rules only concern firm- or industry-specific subsidies not economy-wide ones (e.g. subsidies for poor consumers) which are assumed not to distort trade. Subsidies are considered to be economy-wide if eligibility is determined by objective criteria, not conditional on export performance or the use of domestic inputs, and not limited to a firm or industry within a geographic region.

Pressure from developed countries to liberalise

While the WTO provides governments with complete flexibility to determine the level of obligations they assume under the GATS, the negotiation process is more complex. As noted above, many of the GATS negotiations take place at the bilateral level. This has led to some concern that while developing countries retain in principle the sovereign right to choose which services sectors they offer, in practice they may come under pressure in the negotiations to meet the demands of more powerful WTO Members, which are able to exert influence through their aid programmes. Since water distribution services have yet to be listed

as a sector included under the GATS it is difficult to determine whether such concerns are justified.

However, outside the GATS framework experience in Senegal would suggest that developed countries and their donors do have influence. In 1995, the most important donors in the water sector – the World Bank, the French AfD and the German KfW – pressed for greater PSP as a precondition for allocating more (and much needed) funding to the national water infrastructure. Similarly in South Africa there has also been pressure from other countries to liberalise water services. That said, South Africa is arguably strong enough (economically if not politically) to resist external pressures, and its water sector is by no means donor dependent as is the case in many smaller, Least Developed Countries.

CONCLUSION

Based on current experience of PSP in the water sector there are doubts as to the benefits (investment in infrastructure, efficiency and quality) that would be achieved by developing countries opening up their water services to foreign private suppliers under the GATS. In the absence of effective domestic regulation, and sufficient capacity to regulate, there could also be negative effects on equity. PSP (both domestic and foreign) can result in higher prices (for cost recovery purposes), forcing the poor and marginalised to buy water at much higher rates or leaving them to be provided for by other means (e.g. state provision or stop-gap supplies by water tanker). These apprehensions are particularly acute in the water sector, for a basic service whose availability is essential to all, where there are recognised market failures, political sensitivities and in which governments are heavily involved as regulators, providers and distributors.

But GATS itself neither requires nor precludes a particular regulatory regime. Countries are in principle free (subject to international pressure) to design water services regulations according to their national priorities and development strategies. WTO Members must, however, observe certain GATS disciplines when adopting and implementing particular regulatory instruments. Those countries that want to rely on domestic services and services suppliers in any sector or who want to maintain a maximum degree of regulatory flexibility should consider remaining unbound in that sector i.e. not making any commitments under the GATS. Other countries that want to commit certain sectors (including water) to the market access and national treatment disciplines of the GATS should carefully assess their regulatory regime and the implications of market access and national treatment on it and should, when scheduling limitations on their commitments, also consider their need for future regulatory flexibility. As noted above, sequencing of liberalisation is vital: public authorities need to ensure that adequate regulation is in place before opening up water services to PSP, including to foreign access (under the GATS).

It follows that developing countries, before deciding upon their negotiating stance under GATS in specific sectors such as water (and other sectors of export interest and/or domestic concern) need to assess their strengths and weaknesses in the relevant services sector, the potential costs and benefits of liberalising these services, the role of domestic regulations (and their capacity to regulate) and conditions in shaping these costs and benefits.

At the same time developed countries, including the European Commission on behalf of the EU, need to be sensitive - and be seen to be sensitive - to the local context of the water sector in those developing countries, including the social and political environment, for which they ask to make commitments under the GATS.

In this connection, the initial sending out by the EC and its Member States in 2002 of requests to the 72 countries was unfortunate⁶. The list was not only long, but also heterogeneous, including countries with very different levels of development and with sectoral concerns. It was perceived by observers outside the Commission as being a “blanket” approach to promoting GATS in relation to water services, indiscriminately ambitious and (worse, where it might be combined with conditionalities and/or other donor pressure, as aggressive) as well as not being sensitive to different country contexts.

From the ‘internal’ perspective of trade officials involved in administering GATS requests, a practical question arises: how do they decide which countries to make requests to, and which not? From the outside, the EU requests in 2002 look to have adopted a “mail-shot” approach (i.e. spreading requests widely), as opposed to another option which would have been to seek a more targeted approach. Whatever the internal reality⁷, the fact is that, as noted above, the making of the initial requests to 72 countries attracted substantial external attention including *inter alia* doubts as to whether it had taken into account the status of institutions (if any) for regulating private sector participation⁸.

A key lesson is that liberalisation of water services in developing countries needs to be approached with care - more care than in relation to other services sectors which carry less social and political sensitivities. The characteristics of water services make them significantly different from, for example, telecommunications, banking/finance and other business services. Indeed, trade specialists note that the services least frequently included in GATS schedules of commitments to-date are “social” sectors such as education, health and water.

The exchanges during this project between trade and water specialists have revealed the extent of dialogue and learning required at the GATS-water sector interface. Trade officials need to familiarise themselves with the special features of the water sector. Water officials meanwhile need to build up their understanding of the content of the different GATS rules, how they are interpreted internationally under WTO procedures/auspices, and especially how they may apply to water services.

For developing countries, a gradual approach to making market access and national treatment commitments is likely to be advisable for three reasons.

⁶ As noted above, *revised* requests have since been sent out by the EC and its Member States, in January 2005.

⁷ No information was available to this study on the processes internal to the Commission and to the discussions with/amongst Member States.

⁸ The EC states that it has, subsequent to the 2002 request, shown its willingness to discuss transition periods where developing countries have expressed the need for time to adapt their regulatory frameworks in light of GATS commitments, allowing for a more gradual opening of markets to foreign suppliers. In making its *revised* requests in 2005, the approach followed by the EC was that it allowed vulnerable countries (including all Least Developed Countries) to choose environmental services as an optional sector to commit out of a group of five sectors. In other words, the EC states that the level of development of countries is taken into account in the requests it makes to WTO member countries.

First, regulatory authorities which have little experience of PSP and GATS may not be able to regulate for things they do not foresee⁹. The onus is on countries which make commitments under the GATS to provide limitations to the application of rules concerning market access and national treatment, in terms which are clear and effective for that purpose, to formulate the partial commitments they desire. A cautious step-by-step approach to making GATS commitments would increase the likelihood of understanding correctly how they take effect and in assessing any positive or negative implications (which can be enhanced or mitigated by specifying limitations).

Second, since disciplines for domestic regulation under the GATS are still being developed, finalising GATS rules in these areas would assist countries in making commitments. While GATS rules remain in certain respects a 'moving target', the making of commitments under the current regime will continue to involve uncertainties.

Third, GATS surely presents a considerable capacity challenge for developing countries. Where negotiating or regulatory capacity is lacking in these countries, it is important that developed countries make available technical assistance to help build that capacity, but, as noted above, where such technical assistance is required, it should be provided through third parties who are acting - and are seen to be acting - as impartial advisors.

⁹ The EU WI Code of Conduct, recently drawn up by a multi-stakeholder group and soon to be endorsed by the EUWI Steering Group, is clear on the role of the private sector: "The international public and private sector water operators have much to offer in the way of capacity building, knowledge transfer and management support to partner country water operators. However, the involvement of the private sector in the delivery of water and sanitation services is a National or Local Government choice and service provision should be undertaken in the most efficient and effective manner whether public, private or appropriate combination of the two options."