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**Private Sector Participation
in Water and Sanitation:
institutional, socio-political,
and cultural dimensions**

Paper:

**“Privatisation of the water and sanitation systems in the Buenos Aires
Metropolitan Area: regulatory discontinuity, corporate non-performance,
extraordinary profits and distributional inequality”**

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1. Introduction¹

On May 1st 1993, the firm Aguas Argentinas S.A. (a consortium led, at the time, by Suez Lyonnaise des Eaux-Dumez and the local group Soldati) became responsible for the supply of the potable water and sewer drainage services in the City of Buenos Aires and the main districts of its conurbation. Until then, the supply of the said services had been in charge of *Obras Sanitarias de la Nación* (OSN).²

As was usually the case regarding many of the public utilities privatised in Argentina during the 1990s, the official decision to license the OSN services through Decrees issued by the Executive Power conspired against the legal stability and predictability of the process, thereby greatly affecting the social costs implied. Thus, various Decrees and Resolutions –whose legality was in many cases dubious, and which had been passed under circumstances of complete discretionality, no transparency and no participation of users or consumers- allowed for the continuous adaptation of the original licensing contract to the licensee’s interests. Several phenomena support this interpretation. It would simply be enough to mention the systematic breach of contract incurred by the licensee (in particular, regarding the agreed investments and

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¹ The authors wish to thank Martín Schorr and Camila Arza for their comments and contributions, and of course, exempt them from any responsibility regarding errors or omissions.

² The Metropolitan Area of Buenos Aires consists of the City of Buenos Aires and seventeen districts of its conurbation. In that sense, this is the biggest single license in the world, since it involves a region with a total population of almost 10 million inhabitants.

consequently the service expansion aims), or the active exertion of strong pressures with a view to forcing certain interpretations of the current regulations;³ the constant regulatory modifications which, in all cases, favoured corporate over social interests, thereby undermining the original contract clauses; the *de facto* reformulation of the missions and functions of the sector's regulatory agency (the *Ente Tripartito de Obras y Servicios Sanitarios*, ETOSS); and its increasing subordination to the Executive Power, on the one hand, and to the monopolic corporations strategy of accumulation and reproduction of capital, on the other.

Almost nine years after the license was granted, investments in expansion proved considerably lower than originally committed, with negative effects on the standard of living, especially for the poor population of the Greater Buenos Aires Area. Nor were there any important works undertaken, as established by the original contract, regarding the treatment of sewage disposals, or the design of emergency prevention plans, thus provoking significant – and increasing- levels of environmental degradation.

In this way, within the context of widespread non-performance of the obligations undertaken, the administration of the then-President Mr Menem substantially modified the original contract through successive renegotiations with the firm, and in this way undermined its original aims at the expense of the users. In this sense, the rate scheme suffered several modifications, among which the following are worth highlighting: successive increases in the basic rate; modifications to the financing programme for the expansion of the service; an exchange risk insurance on the income of the corporation against any modification there might be on the exchange rate; and the indexation of rates –fixed at the local currency- according to the development of US prices; the introduction of new instances of price review;⁴ etc. These modifications have eliminated all sorts of corporate risk, at the expense of the rights of the service users and

³ Thus, for instance, in the second semester of 1995, the times of the “tequila effect”, the licensee claimed that “Aguas Argentinas S.A. currently participated in *ongoing negotiations* with the authorities to obtain a *dolarisation of its rates* or, at least, *protection of its income* through the introduction of an *automatic rate revaluation clause* in the case that the peso were depreciated.” (own italics)

⁴ At the beginning of 2002, with the enactment of the Emergency Law N° 25,561 by a new government, a general renegotiation of the contracts with the firms privatised in the decade of the 90s was initiated. For further detail, see *the Post Scriptum* at the end.

consumers, and naturally, they have had an impact on the performance of Aguas Argentinas S.A. (which since the beginning, has made significant revenues and obtained high profit margins – among the highest both at the local and international levels).

In this context, the administration that took office at the end of 1999 not only failed to modify the terms of the said renegotiations (as had been stated during the election campaign), but it also set forth measures which completely supported and continued the work of the previous administration, endorsing a wide range of alterations to the original contract such as, among others, a new rate increase of more than 17% for the period 2001-2003.⁵

The regulatory practice of the Argentine State during the first eight years tended to guarantee extraordinary profits for the licensee, and no corporate risk. This can be seen, for example, in the fact that Aguas Argentinas S.A. obtained a 19% profit rate on its average net worth between 1994 and 2000, whereas the sector standards for “reasonable” profitability vary between 6.5% and 12.5% in the United States of America and between 6% and 7% in Great Britain.⁶

With the purpose of assessing the present situation of the activity as regards its economic regulation, the characteristics of the O.S.N. privatisation process, the main features of the model of regulation emerging from such process (and some of its later modifications), and the regulatory practice carried out, by action or omission, by different instances of the State from the onset of the privatisation are analysed below.⁷ On that basis, it is also intended to identify the most significant impacts on the

⁵ This last agreement remains subject to the results of the current review of the contract, at least for the period 2002-2003. See, again, the *post scriptum*.

⁶ See Phillips, C.; “The Regulation of Public Utilities”, Public Utilities Reports, inc. 1993.

⁷ With regard to this, it should be noted that from the beginning of the license to the present, the contract has undergone modifications. At present, no organised text of the new contract exists, but a set of rules that correct the previous ones. However, the act of the agreement of November 21st 1998, enacted through the Resolution N° 1103/98 of the Secretary of Natural Resources and Sustainable Development, established in its sixth article that the said secretary will be responsible for drawing up the modifications to the license regulations with a view to the elaboration of the corresponding organised text, a disposition which still hasn’t been complied with. See Breslin, G.; “Análisis del régimen tarifario de Aguas Argentinas y lineamientos para una propuesta”, December 2001, mimeo.

economic performance of Aguas Argentinas S.A., which derive from the orientation that the government's regulatory policy has assumed for the sector.

2. Privatisation of *Obras Sanitarias de la Nación*: main characteristics of the process and the emerging regulatory scheme

2.1. Background

From 1812 until the beginning of the 80s, the supply of potable water and sewer drainage was in the hands of the state-owned firm O.S.N. for most of the national territory.⁸ During this period, the main objective of the sanitation policy (based on the notion that the universalisation of the service should be a priority) was the territorial expansion of the service. The policy was financed on the basis of a system that combined the returns from the service charges to users and specific contributions by the National Treasury.⁹

In 1980, under the administration of the last military dictatorship and within the framework of the International Monetary Fund's structural adjustment programmes and the conditions imposed by the World Bank, O.S.N. was divided into 161 systems of potable water and sewerage, and transferred –free of liabilities – to the different provinces. The scope of supply of the firm was thereby reduced to the Federal Capital and thirteen districts of the Buenos Aires conurbation. These measures were taken within a context of increasing de-financing of the public sector, and consequently had a negative impact on the expansion of the services, as well as on the maintenance and

⁸ The corporation coexisted with the National Potable Water Service (which supplied the rural areas), with *Obras Sanitarias de Buenos Aires* (Sanitary Works of Buenos Aires) (which supplied the service in various cities of the Province of Buenos Aires, except in the conurbation), and with some cooperatives and local corporations.

⁹ O.S.N. was basically financed with the returns from the supply of potable water and sewer drainage services (with fixed rates charged to buildings), the application of fees to the work of assessment and supervision of private water services projects, and to a lesser extent, the provision of other services.

rehabilitation of the existing infrastructure. With regard to this, it is important to note that in view of the considerable extension of the Argentine territory and the uneven distribution of its scarce population, the centralised nature of the system had allowed, up until then, its expansion to scarcely populated regions with lower relative development, because its pricing scheme (structured around certain crossed subsidies among different types of users) tended to favour the consumers with the lowest levels of consumption and purchasing power and the relatively less developed regions of the country.

The subdivision of O.S.N. within a context of regressive redistribution of income – both socially and regionally-, acute fiscal crisis and abrupt contraction of public investment greatly limited the service’s capacity of expansion, because the government did not provide for alternative financing mechanisms appointed to promote universalisation. As was expected, this meant, in practice, a considerable deterioration of the water services.¹⁰

As regards the latter, in the period prior to privatisation, the situation in the region covered by O.S.N. presented clear signs of inequality, which was reflected in the fact that the population that did not receive the service lived, for the most part, in the districts with lower *per capita* income.¹¹

Similarly, the state-owned corporation recorded, among other behaviour indicators, a great degree of de-investment (with 79% of the installed pipelines depreciated),¹² a high level of technological obsolescence as regards the treatment of effluents, increasing

¹⁰ This must be highlighted, because it tended to provide a basis to legitimise and implement the corporations’ later privatisation. In this sense, it is important to note that during the decade of the 90s practically all the state-owned corporations which provided the water and sanitation services existing in the country were transferred to the private sector.

¹¹ In 1993, the area covered by O.S.N. was populated by 8.6 million people, of which around 6 million (70%) were connected to the network of potable water and approximately 5 million (60%) to the network of sewers. In the Federal Capital, the coverage neared 100% for both services, while in the area corresponding to the Buenos Aires conurbation the coverage was 35% for sewers and 53% for potable water. For further details, see Ferro, G.; “El Servicio de agua y saneamiento en Buenos Aires: privatización y regulación”, CEER/UADE, April 2000, mimeo.

¹² The state-owned corporation produced 1,350 million cubic metres a year – with losses of about 38% of the total production. At the same time, it disposed of 850m³ sewer waste annually. For a further treatment of this issue, see García, A.; “La renegociación del contrato de Aguas Argentinas S.A. (o cómo transformar los incumplimientos en mayores ganancias”, Realidad Económica Magazine N° 159, October-November 1998.

pollution of the environment through industrial contamination, important neglect of the demand during the summer months, considerable deterioration of the quality of the water delivered, a deficient system of macro and micro measurement (which only reached 15% of the connections), and outdated cadastral information.^{13/14}

In such context, at the beginning of 1991, the Menem administration started to unfold a political-institutional and economic strategy intended to create and guarantee favourable conditions to make the O.S.N. transfer to the private sector effective. In this sense, two measures of policy must be noted which, in their articulation, played a decisive role in the privatisation process of the firm. On the one hand, in strictly economic terms, important increases in the service rates were promoted, in order to make the future license seem more attractive to private capital: in February 1991 a 25% rise was provided for; in April of the same year (already within the framework of the Convertibility Law N° 23,928) another 29% rise in the rates was endorsed; in April 1992 the VAT (18%) was incorporated to the rates; and finally, shortly before the transfer, another 8% rise in rates was introduced.^{15/16}

On the other hand, again at the beginning of 1991, the O.S.N. Privatisation Committee was created, conformed by, among others, representatives of the National Economy and Public Works and Services Ministry, the City of Buenos Aires Mayor's Office, the Province of Buenos Aires Governor's Office, the National Legislative

¹³ See Gaggero, J., Gerchunoff, P., Porto, A., and Urbitzondo, S.; "Algunas consideraciones sobre la privatización de Obras Sanitarias de la nación", *Estudios Magazine*, Year XV, N° 63, July-December 1992.

¹⁴ Despite the operational deterioration of O.S.N., it is important to note the great expansion of the water and sewerage networks recorded prior to the privatisation (especially if consideration is made of the macroeconomic and institutional instability of that period). With respect to this, the available evidence indicated that the total population with potable water increased from 58.5% to 65.2%, while the population with access to the sewerage system increased from 29.8% to 37.2% between 1980 and 1991 (in the Buenos Aires Metropolitan Area, these percentages were higher. At the beginning of the 90s, they reached 70% and 58% respectively) See FIEL; "La regulación de la competencia y de los servicios públicos. Teoría y experiencia argentina reciente", *Fundación de Investigaciones Económicas Latinoamericanas*, 1999.

¹⁵ In this sense, consult Ferro, G.; *op. cit.*

¹⁶ It is important to note that the wholesale domestic price index underwent a 9% increase in the period between February 1991 and May 1993.

Power, the *Sindicatura General de Empresas Públicas* (Controller General of State-owned Corporations), the sector unions (*Federación Nacional de Trabajadores de Obras Sanitarias* and *Unión de Trabajadores de Obras Sanitarias del Gran Buenos Aires*), and various management units of the corporation. The government thereby gave the different interested actors participation in determining the direction of the privatisation policy. In some cases it also involved them in the future composition of the regulatory agency or in the board of directors of the future licensee itself.

In this connection, two important analytical digressions should be made. The first relates to the socio-political and institutional context within which the vast privatisation programme developed by the country, as well as the specific case of O.S.N., was carried out. The second refers to the role of unionism in the stages before and after the privatisation of the firm.

As regards the first issue in question, it should be emphasised that the civil society remained absent from the debates concerning the question of “privatisations” –both in general terms and specifically concerning O.S.N.- limited by the economic crisis and a political environment that imposed the retreat of the State from the economy and its replacement by private initiative as the only alternative against “chaos” (in full accordance with the basic postulates of extreme neoliberalism). While apparently there was enough social consensus to support privatisations, built on the basis of the accumulated deterioration in the quality of the services and promoted by the media sectors favourable to privatisations, the government excluded all consultation and/or participation mechanisms in order to achieving the expected aims. The government’s accumulation of power (promoted by big local economic groups and the external creditor banking) enabled it to impose already- made decisions regarding the process of privatisation and state reform. However, such decisions would have been impossible to make without the support and, mainly, the ideological and financial support of the international financial agencies.¹⁷

¹⁷ The following quotation reflects the World Bank’s position on the issue: “One of the most important services the bank can provide is to ensure that the process of policy reform is internalised in the country as quickly as possible, so that the reform program is designed by the country itself and

The risks associated with the increasing concentration of economic and political power implied by the alienation of the major infrastructure and industrial corporations of the country, were not a matter of public debate. Nor was the social and regional impact of the abrupt application of mechanisms intended to appreciate capital –implied by such transfers- in terms of employment and fixation of prices and rates, in spite of the strong socio-spacial inequality existing in the distribution of income – and which has increased substantially as a result of, among other factors, the ways in which the state-owned corporations were alienated - in Argentina.¹⁸ The various sectors –state workers, academics, neighbourhood organisations, etc- which intended to raise these issues lacked the space to express their ideas and failed to have them incorporated, in any way, to the debate about the ongoing reform. On the contrary, both the government and the neoliberal think tanks that provided their advisory services locally (in consonance with the position of the multilateral credit agencies) dismissed and vetoed all those opinions against the official position basically making use of their privileged access to the media (also involved in the privatisation process and/or, in some cases, commercially linked to the beneficiaries of the destatisation).

The second digression refers to the government's inclusion of the *Sindicato del Gran Buenos Aires de Trabajadores de Obras Sanitarias* –SGBATOS– (Buenos Aires Area Union of Workers at Sanitary Works) in the restricted “negotiation committee”, which proved a key factor in crushing union resistance to the privatisation of O.S.N. Similarly, in order to ensure the continued support of the union during and after the corporation's alienation, the government gave the workers a 10% participation in its ownership, through the “Programme of Shared Ownership” established in the State Reform Law. In practice, the programme allowed the “purchase” of the union's assent

integrated into its long-term development program”, (Johnson and Wasty; “Borrower ownership of adjustment Programs and the Political Economy of reform”, World Bank Discussion Papers, 1993).

¹⁸ Apart from improving, to a certain extent, the efficiency in the supply of the services, these reforms gave rise to a great increase in the unemployment rate, the exclusion of important impoverished sectors of the population from the access to the basic services and an increase in regional inequalities.

to the licensing and to the 50% staff reduction policy which the corporation Aguas Argentinas S.A. would carry out later.¹⁹

2.2 An opportunistic bid

The O.S.N. privatisation process formally started with a national and international invitation to bid (Resolutions SPOyC N° 97/91 and 178/91) meant to select the partners for the future licensee and its technical operator. The bidding involved two major stages or phases: the first one was intended to prequalify the technical bids and the second one was meant to select, among the previously accepted bids, the winning consortium by means of a single-variable criterion: the level of discount offered for the basic rate with respect to the current rate at the moment of the firm's transfer. Within this context, the five groups capable of competing in the second phase were prequalified, by virtue of the Resolution SOPyC N° 53/92.²⁰ In December of that same year (Resolution SOPyC N° 155/92) the bid was awarded to the consortium Aguas Argentinas S.A., *ad referendum*

¹⁹ According to Loftus, A. and MacDonald, D. ("Sueños líquidos: una ecología política de la privatización de agua en Buenos Aires", *Realidad Económica Magazine* N° 183, October-November 2001): the strategy of appointment seemed to be fruitful and the leaders of the SGBATOS changed their initial grievances against privatisation of the public utilities to complete support. They were essentially bribed to "accompany" the process from beginning to end, a process which reduced the staff by half due to layoffs. Similarly, they indicate that the distinction between the union, the board of directors and the regulatory agency is often blurry and sometimes downright inexistent. Undoubtedly, the collusion of these interests in the process meant that the privatisation of the water and sewerage networks of Buenos Aires was easier to promote and intended to benefit and strengthen the elite groups. From the point of view of neoliberal orthodox thinking and those who fully agree with the privatisations of the Menem Administration, considerations in this connection don't differ greatly: the fact that 10% of the shares were given to the workers of former O.S.N. through the programme of shared ownership was intended to "purchase" their assent to the licensing and has been a common practice of the national government to bring the privatisations to completion. With respect to this, see Artana D., Narvajas, F. and Urbitzondo, S.; "Governance and Regulation in Argentina: A Tale of Two Concessions", in Savadorg, W. And Spiller, P. (editors); "Water, Institutional Commitment in the Provision of Water Service", Inter-American Development Bank, 1999.

²⁰ Like in most privatisation processes in Argentina, the establishment of a high fixed minimum worth (in this case, of 1,200 million dollars) became one of the main obstacles for accessing the invitation to bid for O.S.N., and at the same time, constituted a clear sign of the official lack of concern for the dissemination of the share holding of the new suppliers of the privatised services. For further details, see Azpiazu, D.; "Privatizaciones y regulación pública en la Argentina. Captura institucional y preservación de beneficios extraordinarios", paper presented in the IV Congreso Internacional del CLAD sobre Reforma del Estado y de la Administración Pública, Buenos Aires, 5 to 9 of November, 2001.

of the National Executive Power. Finally, by virtue of the regulations in Decree N° 787/93, on April 28th 1993, the licensing contract was signed with the corporation, which was inaugurated in office on May 1st of the said year.

The initial share structure of the successful bidder shows a partnership of transnational capital, whose major partner was the French corporation Suez Lyonnaise des Eaux-Dumez²¹ and the national group Soldati (see table 1). In aggregated terms, corporations with foreign capital were predominant, since they acquired a 50.4% control of Aguas Argentinas S.A., while the local groups' share holdings accounted for 39.6% of the capital stock and the remaining 10% was assigned to the former O.S.N. workers – Programme of Shared Ownership. With respect to the foreign corporations, it should be noted that the French Suez Lyonnaise des Eaux-Dumez is the technical operator of the service, and the remainder are suppliers of the services in their countries of origin (such as the Spanish Sociedad General de Aguas de Barcelona²², the French Compagnie Generale des Eaux and the English Anglian Water Plc.). As regards the local partners, it is important to highlight the presence of two corporations belonging to two local corporate conglomerates²³ (Sociedad Comercial del Plata, belonging to the economic group Soldati, and Meller, to the Meller group), and one corporation related to the financial sector (Banco de Galicia y Buenos Aires).²⁴

²¹ This is one of the most important conglomerate of specialised suppliers of infrastructure and environmental developmental services in the world. The group supplies around 110 million people with potable water and sewerage services in the whole world (25 million in South America, 14 million in North America, 43 million in Europe and the Mediterranean, 23 million in Asia and the Pacific and 5 million in Africa). Besides, it has diversified towards the supply of energy, waste collection and processing and communications. See Schneier-Madanes, G.; op. cit.

²² Spanish corporation where Suez Lyonnaise des Eaux-Dumez has a major share holding.

²³ This association of foreign capital with the big economic local groups is a distinctive and typical feature of the privatisation programme developed in Argentina during the 90s. See, on this issue, Azpiazu, D; "Elite empresaria en Argentina. Terciarización, centralización del capital, privatización y beneficios extraordinarios", Working document N° 2 of the Project "Privatización y Regulación en la Economía Argentina", FLACSO/SECYT/CONICET, November 1996.

²⁴ Later, in favour of the regulatory inexistence of temporary restrictions on the resale of share holdings, Soldati disposed of its holdings (bought by Suez Lyonnaise des Eaux S.A.) as did, partly, the Meller group (now, through Aguas Inversora, S.A.). As a result, the current share composition of Aguas Argentinas S.A. is: Suez Lyonnaise des Eaux S.A. (34.7%), Sociedad General de Aguas de Barcelona (25.0%), Banco de Galicia y Buenos Aires S.A. (8.3%), Vivendi S.A. (7.6%), Aguas Inversora S.A. (5.2%), International Finance Corporation (5.0%), Anglian Water Plc. (4.3%), and Programme of Shared Ownership (10%). It should be noted that the shares held by the International Finance

1.1. Table 1

1.2. Aguas Argentinas S.A.

1.3. Initial Share holding Composition, May 1993

(in percentage)

Share-holder	2. CAPITAL'S ORIGIN	%
Suez Lyonnaise des Eaux-Dumez	France	25.4
Sociedad Comercial del Plata	Argentina	20.7
Sociedad General de Aguas de Barcelona	Spain	12.6
Meller	Argentina	10.8
Banco de Galicia y Buenos Aires	Argentina	8.1
Compagnie Generale des Eaux	France	7.9
Anglian Water Plc.	United Kingdom	4.5
Programa de Propiedad Participada	Workers	10.0

Source: Economy and Technology Department, FLACSO-Argentina, on the basis of official information.

As was mentioned before, the contract was awarded to Aguas Argentinas S.A. on account of the fact that it was the consortium which offered the biggest discount rate – 29.6%- on the current rates at the moment of the transfer, which implied there would be a factor or ratio “K”, worth 0.731, which as such, should be the maximum rate value for the first ten years of the license. The bidder that came in second, Aguas de Buenos Aires-Thames Water International Services Ltd. (where the local Macri group had a share) had offered a discount rate slightly lower (26.1%, that is, a “K” factor of 0.739), whereas the third consortium, led by North West Water International Ltd. –where the local groups Acindar S.A. and Loma Negra S.A. had a share- offered a discount rate of only 11.5%.

Corporation (5%), dependent on the World Bank, come from the capitalisation of a loan granted originally to Aguas Argentinas S.A: and, at the same time, because of its relation with the corporation's high margin of profit, it could be one of the factors that accounts for the aggressive publicity of the “Argentina model” that the Bank is promoting abroad.

Some of the characteristics of the licensing process of the largest single license for the potable water and sanitation services can be drawn from the preceding considerations. Firstly, the small number of bidders is almost surprising –although this is the case in most of the privatisation processes carried out in Argentina²⁵. Because of its own adopted modalities and because of the potentialities it offered, the business should have been very attractive to a considerable number of private corporations-consortiums. However, it was clear that the inexistence of future competition “in the market” translated also, to a certain extent, into the inexistence of competition “for the market”.

Secondly, as is obvious from the bids of the two first winners in the licensing, corporate coordination and lobbying in favour of their own bids held a privileged position. Even more so when the opportunistic²⁶ nature of the bids is brought into consideration, as was clearly shown a few months after the license was awarded. The said bids were structured around “predatory” price proposals, which would later be renegotiated on successive occasions by the licensor. It was further favoured by the inexistence of obligatory contributions of proprietor’s capital (for example, through the purchase of shares); nor was there any obligatory fee for the economic use of public assets.²⁷

2.3. Economic regulation of the license for the service supplied by O.S.N.

²⁵ Azpiazu, D.; “Las privatizaciones en la Argentina. ¿Precariedad regulatoria o regulación funcional a los privilegios empresarios?”, *Ciclos Magazine*, year 11, N° 21, 1st semester 2001.

²⁶ See, among others, Abdala, M. and Spiller, P.; *op. cit.*; Ferro, G.; *op. cit.*; and Lentini, E.J.; “Diagnóstico y soluciones para la regulación del servicio de agua del Gran Buenos Aires. Perspectivas argentina y latinoamericana. Cómo pensar el problema.” January 2000, mimeo.

²⁷ According to Gaggero, J., Gerchunoff, P., Porto, A. and Urbitzondo, S.; *op. cit.*, the decision that the licensing fee should be null has no economic justification, because any profitable fee to carry on the new investments implies in turn the profitability of the preexisting assets (which should be appropriated by the licensor).

2.3.1. Brief analytical digressions on the privatisation design and regulation for the potable water and sanitation sectors

The supply of potable water and sanitation is a natural monopoly with important scale and network economies basically derived from the water and drainage systems that make up the typical infrastructure of urban areas. Because the activity is essentially a monopoly, the possibilities for introducing competition are restricted to the drainage treatment stages, whereas the supply of the distribution service is virtually excluded from any kind of competition.

The high market power that the suppliers of these services usually have is not only due to the monopoly nature of the services, but rather to the fact that the said services are essential for the quality of life of the population –especially as regards health- in the broadest sense.²⁸ This very fact affects the behaviour of the users and consumers' demand, because it renders it insensitive to their price variation. Thus grows the power of the supplier, which can fix the price at the maximum possible level. While there are some regulatory mechanisms intended to reduce the market power of the monopolist through the rise in the demand's sensitivity –for example, the measurement of consumption-, it is still very high basically owing to the lack of alternatives.

Because of the decisive monopoly power of the activity, public regulation is essential to ensure that most of the population can access the service, at fair and reasonable prices that, especially in countries like Argentina, must incorporate basic equality criteria. Undoubtedly, this must be carried out within a framework of strict supervision to prevent the abuse of the supplier's dominant position.

Such regulation should include a component intended to structure the market, and another one meant to limit corporate behaviour, encouraging “competitive” practices. As a general principle, the design of the market structure should tend to isolate, or at

²⁸ The regulation of the activity must be carried out in accordance with the environmental policy, because the administration of the water resources involved in the production and distribution of potable water as well as in the capture and treatment of sewage waste has a determining impact on the dynamics of the ecosystem.

least minimise, the elements of the natural monopoly, thus preventing the corporation established in these segments from extending its power into other related stages or activities (for example, the land market). Although the conditions of a natural monopoly prevail, this does not necessarily imply that vertical integration is the best public policy option. In this sense, the vertical separation of the supply and distribution of water, on the one hand, and drainage, on the other –supported in the integration economies existing between them- is a viable structural option from a regulatory point of view, given that these activities are two distinctive monopolies.²⁹

In this sense, the introduction of “competition by comparison” has been promoted in various privatisation processes, through the creation of regional monopolies. Although the comparison of corporate behaviour can yield important analytical tools for the regulatory practice, it loses efficiency when the different firms belong to the same corporate group or when the number of corporations is too small.³⁰

Corporate behaviour is basically regulated by the price and rate fixing schemes. Through the direct or indirect determination of the levels of profit rate, these support both the “efficient” supply of the services and the necessary investment in long-term fixed capital to maintain the existing infrastructure and expand the coverage to the population that still does not receive the service.³¹

These schemes should be designed considering both the highly intensive use of capital that the service requires³² and the tendency to lack of investment and reduction

²⁹ On this issue, see Vickers, J. and Yarrow, J.; “Un análisis económico de la privatización”, Fondo de Cultura Económica. 1991.

³⁰ On this issue, see Solanes, M.; “Servicios públicos y regulación. Consecuencias legales de las fallas de mercado”, CEPAL, División Recursos naturales e Infraestructura N° 2, September 1999.

³¹ The rate levels are usually legally limited by the principle of rate reasonability, which involves a profit rate equivalent to the one used in activities with similar risk, regardless of the specific regulatory system that is being applied (cost-plus, price cap, and their variations). See Solanes, M.; op. cit.

³² The continual growth of demand and the increase in the environmental demands require great non-cash investments in infrastructure, which usually account for a significant portion of the total costs. The high intensity in the use of capital combined with a relatively scarce technical progress in the production process gives rise to a high capital-income relation –varying between 12/1 and 6/1. Again, see, Solanes, M.; op.cit.

in the quality of the service³³ that is common strategic behaviour of the private corporations carrying out this activity.³⁴ For this reason, the schemes must be complemented with a strict control system of the compliance with the investment plans and the quality standards of the service.

To sum up, it is crucial that there should exist strong and complex public regulation of corporate behaviour as from the moment of the privatisation of the infrastructure utilities, especially when it comes to the potable water and sanitation services, because there is a need to guarantee universal access to these services, protect the environmental balance, restrict high social, economic and political power of the monopolist and ensure the high levels of investment in infrastructure that the activity requires.

2.3.2. General outline of the regulatory frame of the O.S.N. license

As was mentioned before, in April 1993 O.S.N. was privatised by means of an integral license scheme for a period of 30 years (at the end of which the licensee must return the assets to the Argentine State), within the context of the extraordinary powers granted to the National Executive Power by the State Reform Laws N° 23,696 and by the Economic Emergency Laws N° 23,697, made effective in 1989.³⁵ The transfer to the private sector was made effective on May 1st of that year. It should be noted that, unlike the recommendations in the specialised literature, it was decided to maintain both the

³³ A private supplier will always have incentives to reduce the quality of the service in return for reductions in the costs that result in increases in the profits. See Vickers, J. and Yarrow, J.; op. cit.

³⁴ The cost-plus pricing mechanism seems to be more efficient than the price cap to correct the bias towards lack of investment by the suppliers, which characterises the activity, because it renders the profit rate stable over the capital used in the long term. If price cap were applied, and in order to affect future regulatory decisions, the corporations might invest too little deliberately. When presenting to the regulatory agency the weak supply and the more or less poor levels of service, they will be in a better position to argue that higher prices are needed to finance the desired improvements. In contrast, if from the beginning they incur high expenses to improve the levels, the regulatory agency will treat these items as sunk costs, and they will have to resort to legal arguments in support of their demand for higher prices to a greater extent. See Vickers, J. and Yarrow, J.; op. cit..

³⁵ The privatisation and regulation process of the supply of the potable water and sanitation services was implemented by virtue of the application of several Decrees issued by the National Executive Power (Decrees N° 2,074/90, 1,443/90, 1,443/91 and 2,408/91), through which it was established that the service would be licensed. Similarly, in June 1992, through Decree N° 999, the sector's regulatory framework was passed, and the Decree N° 787/93 provided for the award of the license and the model for the licensing contract.

vertical and the horizontal structure of the state corporation. That is, production of potable water was not differentiated from its distribution. Nor were the generation and distribution of potable water separated from the drainage of sewers.³⁶ It was also decided to keep the extension of the area that O.S.N. supplied, thus giving rise to the biggest single licensed sanitation system in the world.³⁷

Within a context of lack of investment and insufficient coverage, universalisation and improvement in the quality of the service became the main objectives of the privatisations, as was established in the *Pliego de Bases y Condiciones de la Concesión* (Terms and Conditions of the Invitation to Bid).³⁸ According to the kind of tender adopted, the license for the service would be granted under a monopoly to the consortium that offered the lowest basic rate –that is, the best reduction on the rate charged by O.S.N.- to develop an investment plan called *Plan de Mejoras y Expansión de los Servicios* (Service Improvement and Expansion Plan) that would, in principle, involve around 4,108 million pesos/dollars throughout the license.³⁹ The mentioned plan was divided into six correlative five-year programmes, the two first being part of the original bid. Besides, the invitation to bid took the following into account:

- A predetermined rate structure that differentiated among residential users, non-residential users and vacant lands;

³⁶ Also, the institutional design dismissed the potential competition by comparison, and furthermore, the possibility of differentiating the license for the supply of the service from the construction of new infrastructure. Both were existing options in countries with a strong tradition of economic regulation of public utilities.

³⁷ The decision to license the corporation, integrated horizontally and vertically for 30 years was unsuccessfully objected to by the World Bank, which proposed to divide the license in order to achieve a certain degree of “competition by comparison”.

³⁸ See resolution of the Secretary of Public Works and Communications (SOPyC) N° 186/92.

³⁹ As was the case with most of the privatisations in the country in the decade of the nineties, O.S.N. was transferred to the private sector free of liabilities (which meant that the national state would absorb a debt of almost 240 million dollars). Besides, the privatisation scheme allowed the winner to lay off a great number of workers, within a voluntary departure scheme. This is particularly important, especially considering that during the first eight months, employment at the corporation was reduced to more than 50% (from 7,800 employees to 3,770), according to the History and Balances of Aguas Argentinas S.A. The sudden reduction in employment directly affected the corporation’s performance: labour average productivity increased 82% during the first year, 55% in 1994 and 12% in 1995. On this latter issue, see Abdala, M. and Spiller, P.; “Instituciones, contratos y regulación en Argentina”, Editorial Temas, 1999. Also, see Duarte, M.; “Los efectos de las privatizaciones sobre la ocupación en las empresas de servicios públicos”, Realidad Económica Magazine, N° 182, august-september, 2001.

- The billing would be mainly effected through a cadastral or “fixed fee” system, defined in terms of the expected consumption by area⁴⁰, which affects the users without any real measurement of consumption (approximately 85%). For those with flow measurement⁴¹, a mixed billing system would be applied, made up of a fixed charge –50% of the “fixed fee”- and a variable charge determined according to the cubic metres actually consumed.⁴² Both billing systems include crossed subsidy schemes between areas and kinds of buildings (involving age and quality and geographic area of the building) intended to favour, in theory, universalisation of the service;

⁴⁰ In this connection, it should be noted that because the previous cadastral structure was left almost unmodified, the licensee has no incentives to keep and/or improve the quality of the service, but rather its profit derives from a better capacity to charge and the land reappraisal of the receiver properties. Even more so when article 17 of the Rate Scheme of the original contract, which established that any modification in the area ratios should be neutral for the firm as regards the amount of the resulting charge, was later suppressed by Resolution SRNyDS N° 601/99. On this issue, see Breslin, G.; *op. cit.*. In Artana, D. Navajas, F. and Urbitzondo, S.; “Argentina: la regulacion económica en las concesiones de agua potable y desagües cloacales en Buenos Aires y Corrientes”, FIEL, December 1996, similar considerations can be consulted.

⁴¹ Measurement was originally compulsory for non-residential users -two years were granted for the set up- and optional for residential users. However, amparo proceedings by the Ombudsman in 1995, confirmed by the Supreme Court of Justice in September 2000, led to the abolition of compulsory measurement in the cases of apartment houses with technical impossibility of measurement by unit (that is, the buildings where only global measurement is possible). Nor was the obligatory measurement for non-residential users with technical possibility of individualisation of consumption complied with, because the ETOSS turned the obligation into an option on the part of the user, unless the firm decided otherwise, through Resolution ETOSS N° 8/95. The rule established that the “silence of the user” enables the firm to automatically bill according to the cadastral system. To sum up, considering the prohibition of global measurement to apartment buildings and the optionality of the measurement system to non-residential users with technical possibility of consumption individualisation, the billing system is now based on the expected consumption by area, although the expansion of the system of micromasurement was established in the Regulatory framework of the License. For more details see Bevillaqua, N.; “El Servicio de aguas y cloacas. Un Estado que actúa a favor de las multinacionales. Aguas Argentinas, gran negocio de la empresa, a expensas de los usuarios”, *Le Monde Diplomatique* N° 26, Edición Cono Sur, agosto 2001.

⁴² In connection with this, see the annexed table at the end of the paper. As is clear from a study previously quoted, the absence of consumption measurement would hinder the effectivisation of a plan to repair the present losses in the transport and distribution networks –estimated at 40% at the moment of privatisation, this meant that the licensee was granted almost complete monopolic power as regards rates, because the State granted it huge discretionality –as was finally the case- to implement the transition from the cadastral system to the measurement system. See Gaggero, J. , Gerchunoff, P., Porto, A. and Urbitzondo, S.; *op. cit.*

- Finally, a new specific charge was determined, also known as infrastructure charge (which included a network charge and a connection charge) intended to finance the network expansion and the incorporation of new users into the service (that is, new connections, or the renewal of those whose life had expired).

With respect to the main aspects of the billing structure of the license, it should be noted first that the scheme established was mainly based on the expected consumption by area, which implies that there is no relation between the firm's current income and the generation of potable water and/or the processing of sewerage waste.⁴³ Secondly, unlike most other privatised utilities, albeit some minor differences, in the case of water and sanitation the scheme of crossed subsidies, pre-existing in the rate structure (from the users with the biggest consumption and income to the users with lower ones; from non-residential users to residential ones; and from geographic areas of greater relative development to the least developed) was not suppressed, in order to avoid a regressive bias in the supply of services which are so essential for the population.

However, the financing programme for the expansion expected for the new users – usually belonging to the sectors with lowest income- turned out to be inequitable and unfair, because the whole charge to that effect fell on that population. The situation was further worsened when, because these new users were unable to pay for the connection, an increasing amount of forfeit debt was accumulated on their real property. The said debt was legally supported in the obligatory of the connection to the service established in the regulatory framework.^{44/45}

⁴³ While the scheme was mainly based on the cadastral records, the regulatory framework of the license provided for the expansion of obligatory measurement. The regulation of such obligation should have been effected during the first two years of the license, but it still has not been regulated.

⁴⁴ This will be analysed later. Still, it should be mentioned that given the high levels of irrecoverability of the debts, the financing programme for expansion was strongly resisted by the new users and was finally replaced in one of the later renegotiations. For a detailed analysis of this question, see Schneier-Madanes, G.; From Well to Network Water Supply and Sewerage in Buenos Aires (1993-2000)", in *Journal of Urban Technology*, Volume 8, N° 3, 2001.

⁴⁵ Similarly, the possibility of stopping the supply of potable water if three consecutive bills were not paid, and of upkeeping the charge regardless of the actual supply of the service, was incorporated, by virtue

In this context, a brief digression should be considered. While orthodox economic theory upholds that the solution to the structural problems of distribution of income – such as the ones existing (and growing) in Latin American countries and especially in Argentina- does not depend on the regulation of the privatised public utilities, the very least principle of social equality necessarily requires that the design of such regulation take this issue into account as one of its main aspects. Otherwise, the mere emulation of regulatory criteria applied in other economies, where the poverty and wretched poverty margins are residuals to the current ones, for example, in the turn-of-the-century Argentina, will not guarantee universality of access to basic and essential public utilities like those of potable water and sanitation. It will rather worsen the already critical situation in the health and quality of life of vast –and increasingly so- layers of the society and thus it will contribute to deepen distributional regression and social exclusion.

The regulatory framework also established rate adjustment or updating mechanisms in principle intended to set clear limits to the variations in the level of the basic rate established in the bidding –although, as is analysed below, the said limits were utterly lax and completely functional to the interests of the licensee:

- A maximum average level of income was fixed for the licensee. It was established that the main variable for the regulation of rates would be the amount of income the licensee received for the services supplied (as a function of the number of users supplied each year and of the efficiency conditions established in each five-year plan).⁴⁶ Besides, provision was made for the regulatory agency to promote the reduction in rate values and prices, with prior approval of the National Economy

of Law N° 13,577 (organic O.S.N. law, passed in 1949, the clause was later incorporated to the Article 75 of the User Rules and Regulations of the licensee).

⁴⁶ See article 47 of the rate scheme in the regulatory framework (Decree N° 999/92). In this sense, the terms and conditions establish (in number 18.12.3.2) that the rate regulation variable set by the said article of the regulatory framework should be calculated in each moment estimating the ratio between the income by the licensee in a certain period and the number of users supplied with potable water and/or sewer drainages in the same period.

and Public Works and Services, if the existence of surplus income from the charges with respect to the regulatory variables were ascertained.⁴⁷ This was meant to protect corporate income, on the one hand, and to safeguard the users from the eventual abuse of monopoly power of the licensee, on the other;

- It was also determined that “extraordinary” rate adjustments could be made as a result of (“extraordinary”) variations of the costs –as long as the increases recorded were higher than a threshold of 7%, according to an index made up of the costs of the main inputs of the firm⁴⁸- or of any event outside the responsibility of the licensee, relevant and unpredictable at the moment of the bid;
- Finally, it was established that changes could be introduced in the rates every five years, as a result of the changes brought on by the Five-Year Plans of Improvement and Expansion of the services. At first, these “ordinary” reviews were distinctly restricted during the first ten years, since it was firmly established that the rate review after the first five-year period (in April 1998) could only result in a reduction of the rates.⁴⁹

When we consider the main components of the economic regulation scheme described before, it becomes possible to ascertain that the maximum rates and prices

⁴⁷ On this issue, see clause number 18.12.3.2 in the *Pliego de Bases y Condiciones de la Concesión* (Terms and Conditions of the Invitation to Bid).

⁴⁸ The possibility of a reduction in the costs was not taken into consideration, which would make an incentive of the price cap kind, since such efficiency increases would be internalised by Aguas Argentinas S.A. in other words, it is a hybrid system of price regulation, because it stands in combination with a cost plus type mechanism when the increases in costs translate into the rates. Anyway, it is important to note that these provisions contradict the strict rules of the public Convertibility Law N° 23,928, which points out in its tenth article that “... under no circumstances will monetary updating, price indexing, cost variation or reempowerment of debts be allowed, for whatever reason, with or without arrears, after April 1st 1991, date in which the convertibility of the austral is enacted”.

⁴⁹ This is expressed in clause 11.11.3 in the Licensing Contract: ordinary reviews will only be referred to the presentation of the second five-year plan and the next ones. In the case of the second plan, to be implemented on the sixth year of the license, the corresponding ordinary review can only result in a reduction of the current rates and prices.

established by the bid explicitly ensured minimal income accrued to the licensee⁵⁰, which in return was obliged to supply its services in the established conditions and to effect the agreed investments for the first ten years of the license. Thus, a minimum value for the return rate on capital was guaranteed, which would also be regulated by the principle of rate reasonability, related to the concept of “normal” or “ordinary” profit that affects –actually, it should condition- the supply of public services that have been privatised or licensed in Argentina.⁵¹ As was mentioned before, the prices and rates should be minimised or reduced in real terms or remain unchanged, save for significant variations –“extraordinary”- in the costs of the licensee, the investment plans or the income by user during the first ten years. For the rest of the period, it was established that the rates would be determined as a function of the costs of supply and expansion of the service, under conditions of efficiency in each of the five-year ordinary reviews.

Finally, it is important to mention that the regulation of the licensing contract and the supervision of the effective compliance with it was left in charge of ETOSS, in whose conformation three jurisdictions are involved (National, Province of Buenos Aires, and the Government of the Autonomous City of Buenos Aires).^{52 / 53} The agency regulates the performance of a single firm and is financed through a fixed proportion of its service billing (2.67%). Both facts contradict the existing recommendations as regards institutional design for regulation, because the regulatory agency does not have

⁵⁰ As is established in the Licensing Contract (number 11.11.1.3) the license is based on the principle of corporate risk. Therefore, if changes in the value of the rates or prices are to be made, no justification derived from modifications in the goods or services market conditions, independent of explicit decisions by the Executive Power, can be invoked.

⁵¹ The mentioned principle was established in the State Reform Law.

⁵² The ETOSS was created through Decree N° 999/92, two representatives of each of the jurisdictions mentioned are members of its board. These are appointed for six years, and the mandate is renewable for a further period. In mid 1999, it was established that users and consumers would have a committee within ETOSS; however, their advisory opinions are not “binding” for the board of the regulatory agency.

⁵³ Originally, the authority in charge of the application of the contract was the Secretary of Public Works and Communication, dependent on the National Ministry of Economy, Public Works and Services. The appointment of the ETOSS board of directors of the national jurisdiction indirectly depended on it.

greater incentives to induce or promote a reduction in the rates (if that were the case, it would affect the income of the licensee and consequently, of the regulating agency).⁵⁴

On the basis of these considerations on the outstanding characteristics of the O.S.N. privatisation process and of its regulatory framework, the following section examines the main elements that characterise the repeated breach of contract clauses the licensee has incurred, as well as the recurrent renegotiations with different instances of the licensing power.

3. State convalidation of the systematic breach of contract, and the redefinition of the original playing field

3.1. The first contract renegotiation in 1994

In spite of the fact that the contract itself strictly forbade any rate review that might be associated with the minimisation or cancellation of corporate risk, and the compensation for negligence, inefficiencies or lack of anticipation, only eight months after the license had been granted, the licensee asked for an “extraordinary review” of the rates, arguing it had had unexpected operational losses.⁵⁵

⁵⁴ There are other aspects, none the least relevant, which strengthen this risk of capture. In fact, as pointed out by Solanes, M.; *op. cit.*, whereas the current regulatory scheme for the Greater Buenos Aires Area stipulates according to the principle of integrated administration of the river basin, that pollution control efforts must fit into the current regulations of the Secretary of Natural Resources and Human Environment (then Secretary of Public Works), the function of water control belongs to the service’s regulatory agency. This distribution of functions is different from the one promoted by the anglosaxon system, where the strictly environmental functions are separated from those related to the supervision of the licensee, in order to minimise the risk of capture.

⁵⁵ Aguas Argentinas S.A. held that the operational loss of 23 million dollars in the first eight months was due to the defficient condition of the user records and to the malfunctioning of the network. In theory, both aspects should have been accounted for by the risk implicit in the proposed rate at the moment of the bidding. See Gaggero, J.; “Privatización de O.S.N. La renegociación del Contrato de Concesión entre el Estado Nacional y Aguas Argentinas S.A.”, 1998, mimeo.

Faced with this request, the Application Authority allowed such review, even when the requirements explicit in the regulatory framework were not met. In other words, with very little objection on the part of the official authorities, the National Economy Ministry gave way to the first modification to the contract with Aguas Argentinas S.A. in June 1994. As a result, the service expansion aims were brought forward and increased, and new investment projects were included;⁵⁶ in return, a rise in rates and prices as from July 1994 was granted. Through Resolution ETOSS N° 81/94, a rise in the general rates was established at 13.5%,⁵⁷ the minimum charge for connection to the water service increased by 83.7%, and to the sewerage service by 42%. At the same time, infrastructure charges increased by 38.5% and charges related to the potable water and sewerage services by 45.7%.⁵⁸ The latter increases⁵⁹ had no technical justification in the terms the modification of the contract and the rate review had been posed; nor did it bear any relation to the price development in the economy.⁶⁰

With this new –and reformulated- rate structure, Aguas Argentinas’ deficit turned into solid surplus during the second year, making almost 350 million pesos/dollars, with a net profitability higher than 50 million pesos/dollars. At the same time, the ETOSS verified the firm had failed to perform a series of clauses stipulated in the contract,

⁵⁶ The supply of potable water and sewerage was included for the population of the City of Buenos Aires that lived in “slums”, and a plan to substitute well water in the Greater Buenos Aires area was incorporated, intended to fight nitrate contamination. See García, A.; op. cit.

⁵⁷ The resolution modified the “K” ratio from 0.731 to 0.830 of the general rate charged by O.S.N. at the moment of the services transfer.

⁵⁸ The mentioned charges varied from 325 to 450 pesos/dollars and 460 to 670, respectively. The next year, the estimation methodology was changed –relatively increasing the connection to the sewerage service- and an average reduction of 14.5% was introduced for their established level (as a result of the transfer to the consumers of the discounts in the employer’s contribution internalised by Aguas Argentinas, S.A.). It is noteworthy, however, that the said charges were extremely high for the population without access to the service and they gave rise to a considerable level of arrears and resistance to payment. According to estimations by the World Bank, after the 1995 restructuring, the average access charges for both services varied between 1,100 and 1,500 pesos/dollars (free of taxes). For more information about this, see Abdala, M. and Spiller, P.; op. cit. Similarly, it is important to highlight that such values are more than five times higher than the current ones in the U.S.A. About the latter, see Schneier-Madanes, G.; op. cit.

⁵⁹ This increase was added to the one applied almost simultaneously with the transfer of O.S.N. to Aguas Argentinas S.A. (at that moment, it was decided that the rates would be increased by 2.67%, apparently to support ETOSS).

⁶⁰ The Wholesale Price Index had increased by 3 % from the date of the bid –January 1992- to the moment of the review, in April 1994.

especially related to the extent in which the works and investments had been made and which, in turn, had provided the basis for the “extraordinary review” of the rates some time before.

The plan of improvement and expansion of the service was not effected as agreed, and during the first three years, non-performance amounted to around 300 million pesos/dollars (45% of the total agreed in the contract).⁶¹ In this connection, the corporation began to argue that social situations such as the growth of unemployment, sub employment and greater marginality were unexpected events which had taken place after the licensing contract had been signed, and as such, they were justifications for the non-performance it had incurred as long as they produced high levels of arrears and the impossibility to recover the debts on infrastructure.⁶² Later on, these same arguments would be upheld by the ETOSS to recommend that the application authority –the Secretary of Public Works and Communication- renegotiate the contract.⁶³

3.2 The second contract renegotiation in the period 1997-1999

In the following years Aguas Argentinas S.A. continued to delay, repeatedly and unduly, the implementation of the investments and the achievement of the aims agreed upon in the contract. Also, it increasingly exerted pressure for, among other things, the dollarisation of the rates, the application of new ways of redress of their high level of arrears in infrastructure charge, the rescheduling of the works plan (specially the Master Plans for Water and Sewerage) and, on the whole, the review of various contract clauses.

⁶¹ It is important to mention that 20 months after the contract was made effective, in December 1994, the firm proposed to modify the Master Plan for Water and the Master Plan for Sewerage, both of which were included in Service Improvement and Expansion Plan. The ETOSS committed the technical assessment of the proposal to the World Bank. The assessment was negative and thus the proposal was dismissed.

⁶² The works that failed to be made mostly corresponded to the expansion of the water and sewerage networks, which should be financed with the infrastructure charge, see Delfino, L.; “La renegociación del contrato de agua potable y desagües cloacales”, CECE, Serie Notas, N° 6, August 1997.

⁶³ On this issue, see the Note to the ETOSS Board of Directors N° 4,457/97 quoted in Gaggero, J.; op.cit.

The official response was once again functional to their interests. In February 1997, the Executive Power summoned a renegotiation of the licensing contract (through Decree N° 149) without very much legal justification. The objective was to deal with the elimination of the “debatable” infrastructure charge, the environmental management of the rivers Matanzas/Riachuelo, the master plans for water and sewerage and any matter that may contribute to the better compliance with the aims of the regulatory framework. Also, the Decree incorporates a series of renegotiation options (among others, the extension in the license term, the deferral of investments, the rescheduling of works, the inclusion of new investments, as well as other areas of the license). Besides, it includes a new anomaly as regards inclusions in –and exclusions from– the renegotiation table: the Secretary of Natural Resources and Sustainable Development⁶⁴ was included, and it would eventually interfere with the management of the license, so much so that it would become the authority in charge of the sector’s rate policy and of the determination of a great part of the works plan; the ETOSS, the sector’s agency for supervision and control, was sidelined for the renegotiation of the contract.⁶⁵

Finally, in November 1997 Decree N° 1,167 was enacted, by which the new agreement signed in September was endorsed. Actually, because of the modifications implied, this meant that a new licensing contract was being put into practice, one with very little resemblance to the original public tender. In other words, while there existed enough ground for termination –given the evident breach incurred by the licensee– it

⁶⁴ This was grounded on Decree N° 1,381 of November 1996. It creates within the said secretary a sub-secretary of hydraulics and environmental ordering, concerned with the development of the national water policy.

⁶⁵ With respect to the gradual ETOSS’ shift as the sector’s regulatory agent, Decrees N° 146/98 and N° 1,369/99 can be consulted. In the recital of the latter decree, it is mentioned that “... given the technical complexity of the issues relating to the regulation of the supply of the water and sewerage services... it is convenient to delegate in the Secretary of Natural Resources and Sustainable Development dependent on the Nation’s Presidency, the faculty to enact the text of the regulatory framework and the licensing contract”. Undoubtedly, the arguments to justify the shift are completely ungrounded (even more so when the ETOSS was precisely created to regulate the supply of the said services) and the delegation of its main regulatory functions to the Secretary of Natural Resources and Sustainable Development (under Ms. María Julia Alsogaray, eng.) was exclusively meant to transfer certain vital elements (like the regulation and development of the rates) to the National Presidency (without a doubt, a much more “permeable” area to the interests of the licensee than ETOSS).

was decided that the contract would be renegotiated so that the new one would be completely compatible with the interests of the licensee, modifying the original conditions under which an international public tender had been summoned. Undoubtedly, no consideration was given to the “legal security” of the initial bidders and mainly, to that of the users and consumers.

In fact, the new contract is no different from the ones that so far had been posed and/or proposed by Aguas Argentinas S.A.. Thus, it is important to highlight the following main modifications –substantial changes- to the licensing contract:

- The incorporation of an exchange risk insurance in the rate regulation (immediate transfer to prices and rates of a devaluation), to eliminate any devaluatory risk from the firm’s commercial operations –more precisely from the income, cost and benefits.
- The elimination of the infrastructure charge and its replacement with SUMA (SU Servicio Universal –Universal Service, MA: Medio Ambiente –Environment), a fixed payment for all users, liable to indexation and readjustments (two or three pesos/dollars per service –water and sewerage-, per user, every two months). At the same time, the new users must pay CIS (a charge for the incorporation to the service), in 30 monthly instalments of 4 pesos/dollars;⁶⁶
- The modification of the “extraordinary” adjustment threshold for increases in costs, from 7% to 0.5%. The argument that the government –which implemented one of the most successful stabilisation programs of the last few decades- applied for this modification was at least ungrounded;⁶⁷

⁶⁶ In both cases, the new charges were retroactive to november 1st, and the estimated aggregated returns is about 100 million pesos/dollars a year.

⁶⁷ Decree N° 1,167/97 points that “...the planned rate review system has been designed taking into account a different macroeconomic scenario from the one that prevails today, which has led to the

- The possibility of an “extraordinary rate review” every calendar year was introduced, contradicting the original concept itself for such reviews. In this context, the licensee requested an 11.7% rate rise as from May 1998, which was rejected by ETOSS. Instead, a 1.6% rise was fixed (ETOSS resolution number 34/1998). An appeal was made by the firm to the new authority on the subject (the secretary of natural resources and sustainable development), which resulted in an additional rise of 3.5% (5.1% in all), retroactive to May, enacted by Decree N° 1,196798 (signed by President Menem some time before travelling to France, country of origin of the leading firm of the consortium Aguas Argentinas, S. A.);⁶⁸
- The coverage term for the first five-year plan was modified (from the end of April 1998 to December of the same year), which meant eight additional months for the firm to be able to fulfil the aims it should have reached at the end of the five-year period; and
- The delay or cancellation of various investments originally agreed upon, and the remission of the non-performance of a series of works which in some cases were “compensated” for with investments like those in the corporate complex Puerto Madero, whose costs –9 million pesos/dollars- were socialised.

After this integral review of the contract by mid 1997, new renegotiations followed. They all shared in common the same rationale as the previous ones. They determined,

consideration of rate modification mechanisms through cost variation that are *only activated in percentages that are completely impracticable in a stable economy like today's*, to the detriment of the economic-financial equation of the contract entered into”. (own italics)

⁶⁸ The rise granted in May 1998, the charge on the rate related to the financing of ETOSS, the 1994 rise and the incidence of the SUMA and CIS charges represents a 7.5% rise in rates with respect to the rate level prior to the tender (it implies a 47% rise with respect to the initial ratio). See Epszteyn, E. and Gaggero, J.; “Privatización y Regulación en Agua y Saneamiento: Area Metropolitana: Antecedentes y situación actual”, June 1999, mimeo.

among other aspects, state guarantee of null corporate risk and of the extraordinary profits internalised by Aguas Argentinas S.A., the rise in rates, the introduction of price adjustment clauses which violated the Convertibility Law, the modification of certain contract obligations taken on by the firm (especially as regards investments and quality and expansion of the service) and, derived from the aforementioned, the official co validation of the evident non-performance the firm incurred.

Thus, in December 1998, the Secretary of Natural Resources and Sustainable Development issued Resolution N° 1,103 introducing significant modifications in the regulatory and contractual framework of the activity. Within the latter regulation and regardless of the deep variation underwent by the rate scheme of the license (successive rises in the “K” ratio, opposed to the original regulatory framework, elimination of the infrastructure charge and its replacement with SUMA⁶⁹ and CIS, exchange insurance risk, etc.), in July 1999, through Secretary of Natural Resources and Sustainable Development Resolutions N° 601 and N° 602, new changes were introduced related with rate regulation. At the same time, the so-called net financial summing-up for the first five-year period (EFNQ) was approved. This, as will be examined later, would be the basis for the determination of the rates for the rest of the license period.

In an explicit attempt to adjust to rate regulatory frameworks of the price cap kind, it was established that the rates would be adjusted by a certain price index, from which an efficiency ratio should be subtracted (this mechanism is also known as “IPD-X”, where IPD is the domestic price index being applied, and X is the referred efficiency ratio). Its application, which promotes a real reduction in the rates, is intended to benefit captive users as it transfers the firm ’s increases in productivity to them, even if only

⁶⁹ This charge was introduced to finance the alleged cost difference between the substitute works that would be made for the sewerage and affluent treatment services, and those planned in the original contract. Thus, environmental aims were included in the contract (originally excluded) and its social object was thus expanded. Besides, it is important to note that the SUMA charge, which considers each connection a unity, is still an inequitable charge because it does not distinguish users by their ability to pay nor by the consumption level. This might mean that connected poor areas are financing the connections in new residential areas related to high socioeconomic levels or in poor areas. See Breslin, G.; op. cit.

partially. In turn, the monopolist can raise its profitability if its operational costs are reduced in a larger proportion than the established one for the reduction in rates.⁷⁰

Openly opposing the lessons taught by economic theory and historical experience (that in the price cap system the “correcting” price index must reflect the development of domestic prices), the selected price index was the simple average between the Producer Price Index –Industrial Commodities and the Consumer Price Index-Water & Sewerage Maintenance, both from the United States, which have lately risen more than the domestic prices and whose application violates the provisions made in the Convertibility Law.⁷¹ The global efficiency ratio (X) was only 0.5% (significantly lower than the ratio usually applied locally and internationally for other privatised services working under the same regulatory framework of the price cap kind).⁷² Also, the fact that inflation in the United States has tended to be higher than an annual 0.5% in the past few years must receive due attention. As a result of it, if the inflation recorded in the mentioned economy of the past few years were to remain unchanged, the application of this IPD-X scheme would give rise to an increase in prices, for example, 2%

⁷⁰ On this issue, see Azpiazu, D. and Schorr, M.; “Privatizaciones en la Argentina. Desnaturalización de la regulación pública y ganancias extraordinarias”, *Realidad Económica Magazine* N° 184, november-december 2001.

⁷¹ This new indexing clause is related to one of the main provisions made in Resolution N° 1,103/98. It incorporates a special form of dollarisation of the licensee’s income (in case the peso-dollar parity is altered, the alteration will be transferred to the rates) and its indexation (as from February 1st 2000). However, the aforementioned regulation presents a special difference from the characteristics that the rate indexation as a function of the United States price evolution assumed in other privatised public utilities. In fact, in most cases (telecommunications, electricity, natural gas, access networks to the City of Buenos Aires, Highway N° 18, etc.), rate dollarisation is a step prior to the adoption of diversionary measures to get round the Convertibility Law. As the latter makes no provision for the currency that may not be indexed, it is assumed that its scope reaches the prices and rates fixed in the local currency (therefore, it would be enough to express them in any other currency –like the dollar- to be outside its scope). In the case of the potable water and sanitation services, such trick wasn’t even applied, the rates are still expressed in pesos, and they are indexed according to the variation in the United States’ price indexes, regardless of the Convertibility Law.

⁷² It should be added, at this point, that the behaviour indicators show an important increase in productivity: the operating costs fell 7.7% between 1994 and 1998, while the population receiving water and sewerage services increased 29.9% and 19.6% respectively in the same period. See *History and Balances of Aguas Argentinas S.A.*

(corresponding to the United States' price variation) – 0.5% (X) = 1.5, and not a reduction, as is intended when this kind of adjustment mechanisms are applied.⁷³

While the government intended to shift into a rate regulation scheme of the price cap kind, at least judging from what is made explicit in the referred Resolutions, the possibility of adjusting the rates through cost or income variation is retained, like at the beginning of the license. This is a mechanism belonging to the regulatory systems of the cost plus or rate-of-return kind (where the supplier or licensee charges a profit margin preestablished above its production costs). For that purpose, the EFNQ is established, estimated as the present value of the net cash flow destined to face the operational expenses and the “efficient” investments during the five-year period in question, which becomes a sort of profitability insurance. Indeed, it was established that should the EFNQ be lower than the originally agreed upon with the authorities, the licensee's income would be adjusted –through a rise in rates and/or perhaps through a state subsidy- so that the initially planned cash flow can be attained and thus the original economic-financial equation. In this way, the new programme imposed by the President Menem's administration still ensures a minimum rate of return but, this time, it has completely transferred corporate risk, both the one related to the operation under efficiency conditions⁷⁴ and the financial and commercial management⁷⁵ –arrears, irrecoverable debts, etc.- to the service users and consumers.

⁷³ The X factor will not contribute to the reduction of the final rates paid by the users in real terms; it will also be superfluous as long as it bears no relation with the “efficiency profits” effectively internalised by the corporation, which rose to an annual cumulative 6.4% for the period 1993-2000. This can be seen in the information, provided by the licensee itself, in a recent study financed by the Public utilities corporations association in Argentina, of which Aguas Argentinas S.A. is a member. See Centro de Estudios Económicos de la Regulación (UADE); “Las empresas privadas de servicios públicos en la Argentina. Análisis de su contribución a la competitividad del país”, 2001.

⁷⁴ In this connection, it is important to mention that the new regulatory framework established the current functioning parameters of the firm as the efficiency criteria to define the EFNQ.

⁷⁵ One of the main objections to this plan is that the definition of net fund flow includes the circulating asset and liabilities variation, that is, the working capital of the corporation. Thus, the assessment of the investment project from which the rate is determined –one of the mayor regulatory problems- and the financing requirements of the investment over time are intertwined. The latter aspect is related to the risk the corporation assumes within this license. For a more detailed treatment of these issues, see Epszteyn, E. And Gaggero, J.; op. cit.

Modifications regarding the financing of the network expansion were also introduced. The SU charge is allegedly insufficient for the purpose of service expansion and it was decided that it would be convenient to attain the system's expansion through works carried out by a third party, financed by the users themselves. That is, the SU is not eliminated (it is integrated to the fixed charge of the bill) and, at the same time, it is established that a great part of the expansion works will be financed by the users themselves (under a scheme similar to the one applied at the beginning of the license, with the very expensive infrastructure charge).⁷⁶

To sum up, for the next few years, a system of rate regulation supposedly based on the price cap mechanism is established (although the abovementioned shows its application will very probably give rise to rate increases), but no major incentives for the corporation to raise its efficiency – a central aspect of the price cap mechanism- are incorporated, since the said system includes “trigger clauses” referred to the increase of rates due to increases in costs or insufficient income, related with the income insurance provided for in the EFNQ.

It is an *ad hoc* mechanism which combines an “inverted” price cap methodology ensuring a rate increase in real terms to the licensee, instead of ensuring a rate reduction to the users, and some elements of the cost plus mechanism, like the transfer of the increases in costs or the compensations for insufficient income to the rates; and thus leaving aside, for example, the setting of a cap to the profit rate. Besides, each new user has to finance his new connection, but the SU charge, originally created for that purpose, is not dropped (therefore, it must be computed as an additional increase in the rates, for its initial “distributional” content is completely distorted).

The possibility of new annual, quinquennial, extraordinary and “*force majeure*” or “fortuitous event” reviews is also incorporated. Regardless of the minor differences between them, they share in common the aim of preserving the privileged returns

⁷⁶ It is important to mention that there are more modifications. For example, the level of free consumption was reduced with respect to the measured rate, the criterion to quantify the actual property area was changed, the surcharges and interest on arrears was modified, contradicting the provisions made in the Consumer Defence Law N° 24,240, and at the expense of users, etc. For more details, see Breslin, G. op.cit.

underlying the unchangeability of the economic-financial equation of the licensee. In other words, corporate risk is nullified and monopolic returns are guaranteed, any consideration on the microeconomic efficiency of Aguas Argentinas S. A. notwithstanding.⁷⁷

In this sense, it can be mentioned as a mere example the fact that between 1994 and 2000, Aguas Argentinas S.A. recorded, on average, a 20% profit rate over its net worth, according to the information in its annual balances. The said profit rate is “only” 13% considering average profitability on sales (see table 2). For the purpose of grasping the extraordinary character of such profit margins, it should be noted that in the same period, the two hundred biggest corporations in the Argentine economy recorded, again on average, a 4.5% profit rate over net worth, which becomes 2.3% in terms of sales.⁷⁸

On the other hand, the profit margins internalised by Aguas Argentinas S.A. during the decade of the nineties are not even close to the levels considered acceptable or reasonable in other countries for the water “industry”. Thus in the USA, for instance, the profit rates obtained in 1991 fluctuated between 6% of the net worth to 12.5%; in the United Kingdom, the reasonable rate for the sector lies between 6 and 7%; in France, an acceptable profit rate is of 6%. In the case of Chile, the relation profit/net worth as a weighted average was 6.5% in 1998 and 8.1% in 1997, with extreme levels

⁷⁷ It is important to note that once the 1999 renegotiation came into effect (it determined, in practice, the conformation of a new regulatory framework, much more functional to the interests of Aguas Argentinas S.A.) ETOSS recovered its character of application authority as regulatory agency, which had been delegated to the Secretary of Natural Resources and Sustainable Development (that is, to the National Presidency).

⁷⁸ In the United Kingdom, the potable water and sanitation systems were privatised in 1989. For the rate regulation, a system of maximum prices on the basis of the wholesale price index plus an adjustment factor K –positive, due to the intensive use of capital and the low productivity of the sector- was implemented. Unlike the Argentine privatisation and regulation experience, the English process became a matter of general public debate over the fact that the licensee had been strongly favoured, to the detriment of the users, during the first years of activity. In the 1992-1993 period, the income of the water companies had risen 23% on average, and the operating income had increased 34.4%, again on average. In March 1994, the water rate absorbed a great part of the income of the population with lower income and its ability to pay became the main element in the determination of the prices. (See Solanes, M.; op.cit.). As a consequence of the increasing social pressure exerted by the users, the system was reviewed by the Office of Water Services in July 1994. The review resulted in the reduction of the adjustment factor, the creation of taxes on contingent profit by companies, and greater consensus was built around the need for the regulatory system to control the profit the companies were making.

varying in the first case between 15.7% (Maipú –medium-sized company) and -6.9% (ESVAL –medium-sized company). In 1997, the extreme values varied between 12.3% (ESSAN) and 0.7% (A: Cordillera). Undoubtedly, this profitability over net worth levels are far more “fair” and “reasonable” than those obtained by Aguas Argentinas S.A.. In this sense, the local profit rates would contradict the regulations, and would only be the result of “unfair” and “unreasonable” rates, unless it was the case that the other international companies were very inefficient, or settled for profitability margins much lower than those recorded by Aguas Argentinas S.A., or operated with a much greater corporate risk.

Table N° 2

**Development of profitability rates for Aguas Argentinas S.A.
1994-2000***

(in percentage)

Years	Profitability over net worth	Profitability over sales
1994	20.0	8.7
1995	14.4	15.0
1996	25.4	15.4
1997	21.1	13.7
1998	12.5	8.4
1999	18.6	12.2
2000	21.4	16.5
1994-2000	19.1	12.8

* Profits are after taxes (net profit).

Source: Economy and Technology Department, FLACSO-Argentina, on the basis of the History and Balances of Aguas Argentinas S.A.

Ultimately, the recurrent renegotiations carried out during the Menem administration (which, as will be analysed later, are not substantially different from those carried out during the De la Rúa administration) in connection with the supply of potable water and sewerage services⁷⁹, presented a similar bias to those carried out in the other privatised public sectors, and have shown the systematic prioritisation of the interests of Aguas Argentinas S.A., in this case, to the detriment of those of the users and consumers.⁸⁰ In this connection, it would be enough to mention that, according to the original regulatory framework, save for exceptional reasons, the rates could not be increased during the first ten years. However, as a result of the successive regulatory changes recorded, not only were the rates increased, but different regulatory reinsurances were introduced so that the said situation would hold over time (exchange risk insurance on the prices –fixed in pesos- and prices’ indexation using the United States’ price indexes, etc.). Undoubtedly, all this meant in practice that a new regulatory framework had been established (completely functional to the capital accumulation and reproduction process of the licensee), which ensured that the licensee would internalise vast profit margins –one of the highest both nationally and internationally.

Evidently, the successive changes in the regulation of the behaviour of Aguas Argentinas S.A., like those in other privatised sectors, tended to guarantee null corporate risk in case the prevailing context changed. In this connection, it is important to present a brief digression. As shown by historical experience, the profit rate for a given economic activity usually bears a positive relation to the corporate underlying risk. In this sense, the case of the privatisation of the Argentine potable water and sanitation systems (and in general, of all the privatised companies) constitutes a *rara avis* in the international context because unlike any expectations, the profit rates have tended to show a reversed correspondence with the respective corporate risk: the lesser the risk, the more profit margins.

⁷⁹ The new regulatory framework established in the various renegotiations was approved by the Bichamber Committee for the Follow-up of the Privatisations, dependent on the Honourable Congress of the Argentine Nation and by the National General Auditor (the latter is always controlled by the opposing party).

3.3. The belated first ordinary license review under the Alianza administration

In view of the evident breach of contract Aguas Argentinas S.A. had incurred during more than five years (despite having achieved several modifications, more specifically reductions, in its obligations, especially concerning the expansion of the eater and sewerage services –as can be clearly seen in the revised information) –made legitimate by regulatory apathy, omission or capture-, it was clear that the De la Rúa administration (which took office at the end of 1999, upholding an alternative policy to the previous one and backed by almost 50% of effective votes) had enough evidence to “terminate” the licensing contract. However, as happened with the other privatised public utilities, the policy the Alianza government undertook did not modify (as was claimed during the election campaign) but rather greatly deepened the criteria which had provided the Aguas Argentinas S.A. license null corporate risk, state guarantee of extraordinary profit and increasing distributional inequality during the previous administration.

In fact, in January 2001, within the context of a renegotiation process of hardly any transparency (and practically without participation of the users and consumers -although a Public Hearing was summoned, the objections made there were not seriously considered) an agreement was signed between Aguas Argentinas S.A. and ETOSS, whereby the second five-year plan was approved (it should have become effective in 1999).^{81/82} In return for its commitment to the fulfilment of its belated investment plan and to the advancement of certain planned works, the government favoured the licensee with a 3.9% annual cumulative rate increase between 2001 and 2003; a 1.5% adjustment for United States’ inflation (1% of which translated into the rates in 2001, and the remainder 0.5% in 2002); and two other fixed charges to be paid every two

⁸⁰ On this issue see Azpiazu, D.; “Las renegociaciones contractuales en los servicios públicos privatizados. ¿Seguridad jurídica o preservación de rentas de privilegio?”, *Realidad Económica Magazine* N° 164, may-june 1999.

⁸¹ It is important to mention that more than a year after the agreement was signed between the corporation and ETOSS, the said agreement has not been published officially.

⁸² The so-called Service Improvement and Expansion Plan (PMES), corresponding to the period 1999-2003, commits the corporation to make an investment of around 1,100 million pesos/dollars.

months (1.55 pesos/dollars per bill.^{83/ 84} As a result, the average rate increased 9.1% during 2001 (a percentage that would grow, through the current renegotiations⁸⁵ to almost 20% at the beginning of 2003).⁸⁶

In other words, it will again be the users that will finance the investments that the licensee agrees to make (most of which, it is important to emphasise, are related to the network expansion and/or improvements in the service quality –many of them were agreed upon in the original contract and/or in its successive renegotiations, and therefore, unfulfilled and officially pardoned- which favoured the lower income social sectors of the Federal Capital and the Buenos Aires conurbation).⁸⁷ Therefore, as a result of the latter contract renegotiation, the interests of the licensee were again favoured –and its “legal security”- at the expense of the users and consumers’. In fact, it was not only determined that the new investments would be financed by strong price increases, but the government ended up backing a set of important failures with clearly

⁸³ The charge for “renovation of connection” (tending to finance the renovation of the household pipelines older than 30 years) and the one intended to finance the so-called Integral Sanitation Plan (whose main objective is the construction of a sewerage waste treatment station in the City of Buenos Aires).

⁸⁴ The agreement signed by ETOSS and Aguas Argentinas S.A. also establishes that those users who have no recorded ownership of the buildings in which the service is supplied will pay a 1 peso/dollar per bill charge every two months as from April 1st 2001 (until that situation is regularised). The fact that a fine has become the financing mechanism for investments is completely illegitimate as such, arbitrary in distributional terms and contrary to the “legal security” of the users. Likewise, the works in charge of a third party, paid by the users, are also recognised as a financing means of the new investments. Through this, the licensee makes a discount on the final rates to those users who carry out their own expansion works through such mechanism.

⁸⁵ Again, see the *post criptum* at the end of the paper.

⁸⁶ Among the main works that Aguas Argentinas S.A. is committed to make in return for the rate increase are: the construction of the said treatment station of the sewerage fluids in the Federal Capital, the expansion of the water and drainage network (especially in the conurbation), the renovation and/or rehabilitation of the installed pipelines and equipment, etc. It is important to highlight that as the period has been going on for almost two years, some of the proposed works have already been undertaken.

⁸⁷ PMES establishes that part of the rate increase resulting from the last contract review will be used to finance the so-called social rate (intended to facilitate access to the service to the population with lower purchasing power Aguas Argentinas S.A. supplies). This is an implicit subsidy of 4 pesos/dollars per service and every two months on the fixed charge of the measured and non-measured residential users. Again, this suggests that the licensee’s economic-financial equation will remain unchanged. Judging from the significant profit gaps existing between Aguas Argentinas S.A. and other companies which supply similar services abroad, the constitution of a fund destined to finance the implementation of the social rate could have been conformed with a quota-share of the huge set of benefits internalised by the licensee from the beginning of activities (in many cases, related to the illegal misappropriation of resources) without affecting the extraordinary profitability margins it recorded.

regressive implications in distributional terms. It goes without saying that all of this contributed to the establishment of a regulatory framework very different from the original.⁸⁸

Based on the preceding considerations, it can be argued that the results obtained by the Alianza (President De la Rúa administration) in the renegotiations with Aguas Argentinas S.A. were nothing like the election proposals, where they emphasised the reduction in public utility rates as one of the main governance measures. On the contrary, the rates have not only been increased (through the application of adjustment mechanisms which violate the Convertibility Law), the opposition's objections to the Menem administration have also been validated and legitimised. In fact, the last renegotiation (prior to the integral one, of all the contracts of privatised corporations – see note n° 4) is simply a copy of the preceding ones, both in form (no transparency, “closed doors” negotiation), and in content (finance of works –many of which had been agreed upon beforehand- with important rate rises, consolidation of the guarantee of null corporate risk, preservation, if not increase, of the extraordinary and privileged profits of the licensee, complete subordination of the interests and rights of consumers and users, etc.).

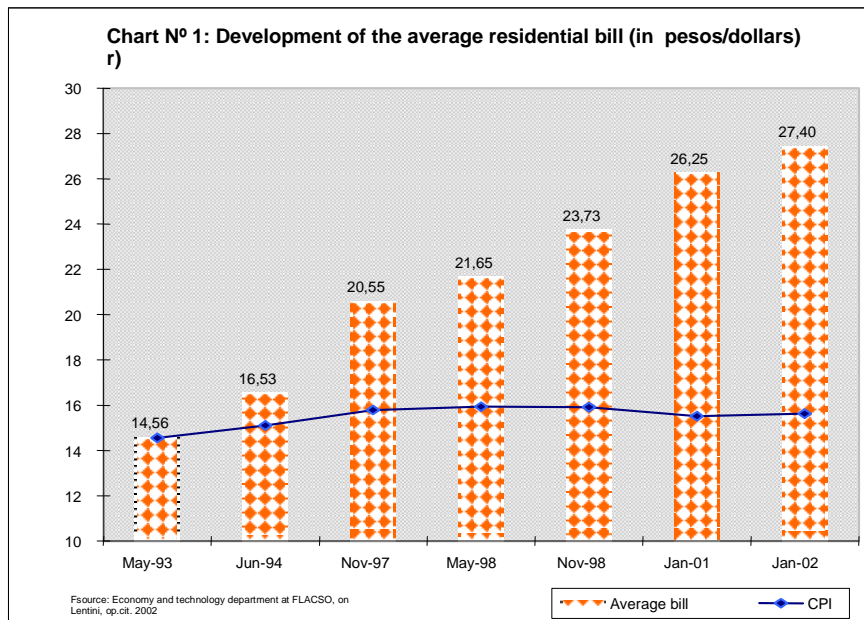
In this connection, it is undoubtable that the large profit margins internalised by Aguas Argentinas S.A. from the moment it took charge of the supply of the potable water and sewerage services in the Metropolitan

Area are closely linked with the multiple renegotiations that followed 1993 and, therefore, with the rate policy applied.

In this sense, Chart N° 1 highlights that as a result of the successive rate increase allowed by the government, the average rate for the residential service increased,

⁸⁸ There is clear continuity between the new administration and the previous one in terms of lack of transparency in procedures. For example, the mentioned agreement establishes that if by December 31st 2001, all the necessary resources to complete the expansion planned to be financed with extraordinary resources and works by a third party have not been obtained, it is agreed to analyse the situation and take the measures that will allow the attainment of such aim. Thus, the agreement opens the possibility for further non-performance and, consequently, for new renegotiations during the current five years.

between May 1993 and January 2002, by 88.2%.⁸⁹ The initial 26.9% reduction, with which the corporation was granted the license, was more than compensated for (this is particularly important because the original regulatory framework established that prices could not be increased during the first ten years, unless costs increased in such a way that a rate increase would be justified, and they could even be reduced as a result of the ordinary reviews).⁹⁰ It is important to add that the rate increase bears no relation whatsoever with consumer price variation, which grew 7.3% between the beginning of the license and January 2002.



On the other hand, considering that, according to a study by Epszteyn, E. and Gaggero, J.; op. cit., the corporation has failed to comply with 63.5% of the amount committed to investments during the first five-year period, the regulatory authority had the obligation and the competence to prevent and/or remedy the illegitimate appropriation of the resources implied –920 million pesos/dollars- through the

⁸⁹ Lentini, E.; “El impacto en la concesión de agua y saneamiento del Area Metropolitana. Un análisis preliminar”, I.A.S.P.; Seminar “Los servicios públicos en el nuevo escenario económico”, ETOSS, Buenos Aires, February 2002.

⁹⁰ For example, it is important to note that the “K” factor fixed in the last renegotiation in 2001 (0.9574) is 31% higher than the one that made Aguas Argentinas S.A. the winner in the bid.

compensatory adjustment of the rate levels expected in the original regulatory framework. However, ETOSS validated, in practice, the abuse of monopoly power Aguas Argentinas S.A. incurred, ensuring that it could appropriate extraordinary profit and transferring the whole risk to the users through the successive modifications to the contract.

4. Economic performance of Aguas Argentinas S.A.

This section examines the development of income in relation to the number of users (the regulatory variable established in the original regulatory framework) and the behaviour of costs in general and of operational costs in particular (both in absolute and relative terms), as an illustration of the impact of the changes in the public regulation described above on the licensee's economic performance. A series of conclusions can be drawn as a result, of special relevance in terms of the potential sources of the privileged profitability that Aguas Argentinas S.A. has been internalising from the moment it took charge of the supply of the services.

Despite the high levels of bad debt the company had to face during the first years (especially, the infrastructure charge), the net income grew 68.6% in the period 1994-2000. The said increase was more than proportional to the number of users (connections), which expanded 31.5% in that period. It is important to mention, in this sense, that between 1994 and 2000 – a period during which, as was analysed, the contract was completely redefined- the rate regulation variable “income per user” varied from 145 pesos/dollars to 195 pesos/dollars (that is, it increased by 27.6%), within a context of complete lack of action by the licensor in general and the ETOSS in particular with respect to the necessary protection of the rights of users in view of the “illegitimate” appropriation of resources of the licensee (Table N° 3).

Table N° 3

Development of the rate regulation variable (income per user), 1994-2000
(in thousands of pesos/dollars and absolute values)

	Income 2.1.1.1		Income/Users 2.1.1.2
Period		Total users Number	
1994	304 980	2 103 310	0.145
1995	360 779	2 252 364	0.160
1996	377 157	2 301 202	0.163
1997	419 998	2 342 432	0.179
1998	436 722	2 540 558	0.172
1999	510 958	2 611 064	0.195
2000	514 246	2 633 735	0.195

Source: Economy and Technology Department, FLACSO-Argentina, on the basis of the History and

Balances of Aguas Argentinas S.A., and information of the Users' Committee at ETOSS.

The s

Committee at ETOSS,⁹¹ the company's investment only reached 63% of the population in the original bid (1,078,000 inhabitants) for the potable water service, and 88% for the sewerage service (812,000 inhabitants) during the first five years,⁹² only considering the investments made by the licensee. Besides, it should be noted that given the almost null elasticity-price of the demand for both

⁹¹ See Users' Committee at ETOSS, "Propuesta de la Comisión de Usuarios frente a la revisión quinquenal del contrato de Aguas Argentinas", August 2000, mimeo.

⁹² This period was further extended by eight months (till December 1998) through Decree N° 1,167/97, granting a longer period for the company to alleviate its high degrees of non-performance.

services, related to the low measurement level, the main increase of the company's income is directly linked to the recurring increase in the rates authorised by ETOSS and the National Government.

On the other hand, if the expansion derived from the works on account of a third party (which represent 37.5% of the network expansion in the case of potable water and 95.5% in the case of sewerage drainage during the first two years), mostly from works initiated under O.S.N., is also included, the levels of non-performance equally grow between 40% and 46% -whether the original aims are considered or the ones reformulated by Resolution ETOSS N° 81/94 and by Decree N° 1,167/97-, and around 60% in the case of sewerage expansion (see Table N° 4).⁹³

Table 4

Water and sewerage services: included and to-be included population during the first five-year period (extended)

(in thousands and percentage)

⁹³ In connection with the actual compliance with the expansion aims originally committed by Aguas Argentinas S.A. and on the other hand, with the inconsistencies associated with basic information that are usually present in the various studies on the company's operation (see quoted bibliography), it is important to include certain specifications basically referred to the corresponding temporal horizon of analysis involved in the said studies. Firstly, as can be seen in the preceding note, the first five-year period was five years and eight months long –according to Decree N° 1,167/97. While the first ordinary review should have been carried out in the first few months of 1998 according to the contract –up to 45 days before the end of the first five-year period- it suffered several delays, directly related to the reformulation of the regulatory framework itself with Resolutions SRNyDS N° 601/99 and N° 602/99. The delayed ordinary review (information was received from the Users' Committee) started at the beginning of 2000, the Public Hearing took place in June 2000 and the Agreement was formalised, as was pointed out, on January 9th 2001, although never officially published and, in many legal experts' view, with dubious legal grounds. To sum up, the first five-year period extended seven years and eight months, whereas the second one would only include three years. For this reason, in many studies problems arise related to the actual timing of the information provided by the licensee and/or the regulatory agency, always referred to that “long-lived” first five-year period. In this study, the information being analysed on the degree of compliance of the expansion aims relates to the actual first five-year period (in some cases, extended and including those additional eight months, when so, they are discriminated) until May and/or December 1998.

	Water	Sewerage
According to original bid	1709	924
According to Resolution Etoss Nº 81/94	1764	925
According to Decree Nº 1,167/97	1504	809
<i>Service expansion</i>		
I. Works by AASA	631	112
II. OPCT*	286	287
III. Regularisation of illegal users	172	152
Real expansion of the network (I + II)	917	399
<i>Degree of effective compliance</i>		
(not considering regularisation of illegal users)		
With respect to the original bid	53.7%	43.2%
With respect to Resolution Etoss Nº 81/94	52.0%	43.1%
With respect to Decree Nº 1.167/97	61.0%	40.3%

OPCT: Works on account of a third party paid by the users.

Source: Economy and Technology Department, FLACSO-Argentina on the basis of the History and Balances of Aguas Argentinas S.A. and information from the Users' Committee of ETOSSS.

In addition, considering that the strong income increase was more than proportional to that of costs – which, in terms of operational costs increased only 2.8% between 1994 and 2000,⁹⁴ any consideration about the other cost components (oversized in some cases and strongly influenced by corporate policy of resorting to external financing at the expense of own capital contributions, in

⁹⁴ As shown by the information provided by the respective History and Balances of Aguas Argentinas S.A., the operational costs corresponding to 2000 (188.7 million pesos/dollars) are not very different from those corresponding to 1994 (183.6 million pesos/dollars).

others)⁹⁵- it is possible to state that both the rate policy and the non-performance of investments account for the high profitability rates internalised by Aguas Argentinas S.A.

Moreover, as no restriction was established on the licensee's borrowing capacity, the company has been increasingly resorting to external financing (International Finance Corporation⁹⁶, the European Investment Bank and various negotiable bonds)⁹⁷, so much so that in the balance closed on December 31st 2000, the ratio total liabilities/net worth rose to 2.49, when in the original bid the indicator was not supposed to become higher than 0.8%.⁹⁸

In other words, despite the company's increasing borrowing,⁹⁹ the reluctance to contribute its own capital (unlike its attitude towards the profit distribution and transfer abroad) has resulted in systematic and, in most years, increasing non-performance of the investments committed. As shown in Table N° 5, the committed and no performed investments during the first five-year period added up to almost 700 million pesos/dollars (57.7% of the total). If these levels were to be taken to the "extended" five-year period, they would add up to 750 million pesos/dollars (57.9% of the committed investment).

⁹⁵ However, it is important to highlight that as shown in the information in the History and Balances of Aguas Argentinas S.A., there was an important modification in the cost structure of the company. Those related to the service operation reduced their relative importance and those related to marketing, administration and external financing increased it substantially. Between 1994 and 2000, the operational costs shifted from 66.9% of the total costs to 45.1%, while those related with marketing from 15.9% to 20.4%, those related to administration from 8.9% to 18.2% and those related to financing (closely linked to the systematic credit absorption from abroad) from 0.3% to 13.8%.

⁹⁶ It is important to mention that more than 20% of the current –and large- external debt of Aguas Argentinas S.A. corresponds to credits previously granted by the International Finance Corporation (linked to the World Bank) which in turn has a 5.0% share in the present holding of the consortium. See Lentini, E.; op.cit., 2002.

⁹⁷ According to Lentini, E.; op. Cit., 2000, the important thing is that the license is basically financed on the basis of the financial institutions which participate in this project finance and not on the basis of its own capital.

⁹⁸ With the financing agreements with the International Finance Corporation, the company committed to reduce the ratio to no more than 1.9 from the 1st of January, 2003.

⁹⁹ According to the information in the History and Balances of the company, the loans granted increased between December 1994 and December 2000, from 128.4 million pesos/dollars to 561.8 million pesos/dollars.

Table N° 5

Non-performance of investment by Aguas Argentinas S.A., 1993-1998

(in millions of pesos/dollars at supply values)

	1993	1994	1995	1996	1997	1998*	Totales
Bidder investments	101.5	210.52	302.91	362.36	229.10	83.07	1289.46
Performed investments	40.93	144.55	132.17	100.49	109.52	15.41	543.07
Non-performance	-60.57	-65.97	-170.74	-261.87	-119.58	-67.66	-746.39

* Corresponding period: May-December 1998.

Source: Economy and Technology Department, FLACSO-Argentina on the basis of the information provided by the Users' Committee of ETOSS.

5. Summary and final considerations

The privatisation of the supply of the potable water and sewer drainage services in the Buenos Aires Metropolitan Area was mainly intended to universalise the service and improve its quality. The fulfilment of these objectives necessarily required the development of new infrastructure as well as the rehabilitation and modernisation of the already existing one.

With respect to this, the alleged "state incapacity" to make those investments under efficiency conditions was the central argument posed by the neoliberal reformers to justify the need for the privatisation of O.S.N at the beginning of the nineties. In addition, because the investments were strategic for the welfare and health of the population, the free transfer of the operational rights of the assets, which had been accumulated by the state-owned company (that is, by the Argentine society as a whole) over more than eighty years, to private hands was justified, in return for the least rate possible for the supply of the service. Therefore, the basic rate that became the winner of the bid not only allowed the financing of the investments corresponding to the first ten years (strictly defined in the terms and conditions and in the contract), but it also and at the same time became the exclusive mechanism to access the services for the actual and potential users.

Almost nine years after the license was granted, the non-performance of investments incurred by Aguas Argentinas S.A. –reaching until December 1998 746 million pesos/dollars which represent 58% of the agreed amounts-¹⁰⁰, under such institutional capture that not only permitted the illegitimate internalisation of extraordinary profit related to the operation of the services, but also promoted successive increases in its basic rate and prices, undoubtedly express the failure of the privatisation process in terms of its own aims. At the same time, it implies serious economic and social damage to the population in the Metropolitan Area of Buenos Aires (above all, for those with lower income).

The behaviour of the licensee (which combined non-performance of the assumed obligations with pressure on political and institutional power to change the contract clauses to its own benefit from the start) suggests that the winning bid was opportunistic and predatory, intended to redefine to its favour the operating conditions after the licensing. For this purpose, once the license was effected, the company seems to have made use of the power granted by the loss of legitimacy the government would have had if the privatisation had failed.

At the time of the belated ordinary review of the first five-year period, the De la Rúa administration ignored the existence of preestablished conditions for contract termination. In this sense, according to the licensing contract with Aguas Argentinas S.A., the National Executive Power could unilaterally terminate the licensing contract on the grounds of serious non-performance of the legal and/or regulatory obligations, repeated and unjustified delays in the performance of the investments and agreed aims.

In this general context, the Argentine case is very probably more than exemplary, in comparison with considerations about even the analysis of international experiences which were much less traumatic –as regards their economic and social impact- than in Argentina. “...It is in the water industry

¹⁰⁰ See table 5.

where the risks of privatisation seem to be the highest, because there is a combination of concerns about the environment, the natural monopoly and the investment in infrastructure. Although there may be a certain margin for the subcontracting of some operations (for instance, drainage treatment and pipeline maintenance), in general there will be little profit from the water industry privatisations, and there are great challenges at stake if the privatisation is undertaken” (own translation).¹⁰¹

¹⁰¹ See Vickers, J. and Yarrow, J. op.cit. This seems to be the case of other two failed Argentina experiences as regards the privatisation of the potable water and sanitation systems: Aguas del Aconquija in the Province of Tucumán, and Azurix, in Buenos Aires. Both process ended up in the restatisation of the service supply.

ANNEX: CURRENT RATE SCHEME, DECEMBER 2001

3 UNMEASURED OR FIXED FEE SYSTEM

Max { TBBNM, TM }

$$TBBNM = \{ [(Sc * E * St / 10) * Pm^2] * Z * K + SUMA \} * (1 + TETOSS + TIVA)$$

with $0,64 < E < 3,88 \vee 0,8 < Z < 3,5 \vee K = 0,917$

TBBNM: Basic rate of the unmeasured system, every two months

TM: Minimum rate by category of user by service

Residential I: \$4,00*K

Residential II: \$1,00*K

Non Residential I: \$8,00*K

Non Residential II: \$2,00*K

Vacant: \$3,00*K

Sc: Total covered area

St: Land area

E: Ratio of age and kind of building

Z: Ratio of geographic building area

K: Discount ratio on the basic rate offered by the licensee

(K winner of the bid was 0,731)

Pm²: General rate by category of user by service*

Residential: \$0,0279/m²

Non Residential: \$0,0558/m²

Vacant: \$0,00279/m² with SC=0

*sewerage is 10% more expensive in the inner Buenos Aires area

SU: \$2,01 charge for universal service every two months per service as from 1/11/97, for covered customers

MA: \$1,98 fixed charge for environmental improvement per bill as from 1/11/98

TETOSS: charge for the financing of ETOSS (0,0267)

TIVA: charge for VAT (0,21)

Measured system (global or individual)

$TBM = \{ 0,50 * \text{MAX} \{ TBBNM; TM \} + [Pm^3 * (m^3 - X m^3) * K] + SUMA \} * (1 + TETOSS + TIVA)$ –fixed charge– –variable charge–

TBM: rate of the measured system every two months

TM: minimum rate by user category and by service

Pm^3 : price per cubic metre of potable water and sewage waste

\$0,66*k (water and sewers) or \$0,033*k (water)

$(m^3 - X m^3)$: m^3 consumed minus the free consumption

free consumption by kind of user every two months

$R = 0 m^2$ (as from April 2001, previously, free consumption was $30 m^2$)

$NR = 0 m^2$ $B = 0 m^2$

K: discount rate on the basic rate offered by the licensee

(K winning the license was 0,731)

SU: \$2,01 charge for universal service every two months per service as from 1/11/97, for covered customers

MA: 1,98 fixed charge for environmental improvement per bill as from 1/11/98

TETOSS: charge for the financing of ETOSS (0,0267)

TIVA: charge for VAT (0,21)

For both billing systems:

CIS: charge for integration to the service, \$8 every two months per service as from 1/11/97 for new customers, payable in instalments every two months during the five years after the incorporation

Fixed charges SU, CIS y MA are liable to future increases in K y VAT (21%)

Source: Economy and Technology Department, FLACSO-Argentina, on the basis of information from ETOSS, and the Centro de Estudios Económicos de la Regulación (UADE); op. cit..

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Post Scriptum

Aguas Argentinas S.A. in the presence of the economic emergency in early 2002

4. I. ANTECEDENTS

At the end of year 2001, the Argentine went through one of her most dramatic political and institutional crises, natural correlate of the deep economic and social collapse. Amongst other manifestations, the crisis was reflected in four consecutive years of economic recession, growing and alarming levels of poverty (more than 40% of the total population), unknown levels of indigence (4 million inhabitants, more than 10% of the total population), high rates of unemployment and underemployment, unsustainable fiscal deficit, growing disequilibria in the external sector and recurrent renegotiations of an unplayable external debt –in terms of what was originally agreed as well as in what emerged from the opaque subsequent renegotiations.

In this context, took place a massive demonstration (of mixed social class nature, with the obvious exceptions). It was a spontaneous and peaceful protest (even when it was brutally repressed), but it had a solid and unbreakable determination in demanding a radical change in the governmental institutions and, naturally, in the strategic orientations of public policy (in particular, in economic and social policy).

As a result, on December 20th 2001, President De la Rúa resigns followed by all his cabinet. Given that the vice-president elected in 1999, had resigned a few months after taking power, it was necessary to put in practice the institutional mechanisms established in the National Constitution for the replacement of the resigning president. This led to the designation, on December 21st 2001 of the recently elected President of the Chamber of Senators, Senator Ramon Puerta (representative of the Justicialista Party)¹⁰² as the provisional president of the country. Following the constitutional mechanisms, Senator Puerta called a Legislative Assembly, which was to elect a new

¹⁰² It is important to mention that the results of the parliamentary elections in October 2001 allowed the opposition (Justicialista Party) to control both, the Chamber of Deputies and the Chamber of Senators.

president to finish the governmental period of the resigning president De la Rúa (until the end of year 2003). The Assembly took place on December 22nd and designed the then Governor of the Province of San Luis, Rodríguez Saá (also from the Justicialista Party) who swore as the provisional president on December 23rd 2001.

However, the new government administration was weakened by several coexisting facts and policies. Among them were announcements considered quite progressive (such as the creation of one million new employment positions), the unilateral declaration of the default on the external debt, the configuration of a monetary system based on three currencies and a very heterogeneous cabinet that tried, in some sense, to respond to the different currents within the Justicialista Party (including, for example, some civil servants highly questioned for their past experience in public offices), on the one hand, and the persistent popular movement (the well-known “cacerolazos”), the political conflicts within the now governing party, the pressures of diverse local group lobbies and the growing pressures from abroad, on the other.

In this context, on the last day of year 2001 President Rodríguez Saá resigned. Senator Puerta who, being the President of the Senate, had to replace him, alleged health problems that prevented him from taking office. Finally, the President of the Chamber of Deputies, Deputy Caamaño (also from the Justicialista Party) took on the government and called for a new Legislative Assembly. Finally, on January 1st 2002, Senator Duhalde was designed provisional president of the country up to the end of year 2003, and swore on January 2nd 2002.

These twelve days that separated the resignation of President De la Rúa from the assumption of President Duhalde are probably an internationally unique phenomenon. In the frame of the republican institutions five different constitutional presidents succeeded each other. It is in this context of deep political and institutional crisis in which some of the first -and very important- policies of the new government have to be interpreted. As will be shown later on, some of these policies implied -or could imply- substantive changes in the relation of the State with the privatised firms in general, as well as in what specifically concerns to the concession of the potable water and sewerage systems in the Buenos Aires Metropolitan Area.

In effect, already in the context of the default on the external debt, the new Duhalde Administration forwarded the National Congress a project for an Emergency Law. It was sanctioned on January 6th 2002, with parliamentary support from the previously governing party (most of the legislators for the Unión Cívica Radical and some of the ones for the Frente País Solidario, the main two parties that constituted the Alianza up to late 2001).

This new legal norm of “Public Emergency and Reform of the Exchange Regime” (Law N° 25,561) determined decisive changes in the macro economy (such as the abandonment of the Convertibility regime through the devaluation of the peso, with the modification of the parity one peso = one US dollar). It also tended to the “pesificación”¹⁰³ of the local economy, as well as to the redefinition of the contractual relations with the privatised firms prevailing during the nineties. In the context of devaluation, the redefinition of the contractual relations pointed to -at least- revise and renegotiate some of the privileges the firms enjoyed during the previous decade (as was the case of Aguas Argentinas S.A. among others).

5.

6. II. THE LAW N° 25,561 AND THE PRIVATISED FIRMS

Firstly, and as a crucial antecedent to understand the transcendence of the matter, it is appropriate to highlight that the privatised firms in general, and particularly Aguas Argentinas S.A., have been internalising a multiplicity of privileges, unknown for the rest of the local economic agents. This refers, among other, to the fact that they operated in monopoly markets, enjoyed the manifest weakness of the regulator (functional to their interests) and the “dolarisation” of the prices of the services they

¹⁰³ “Pesificación” is the process of converting all the existing contracts denominated in dollars to ones denominated in pesos, using different exchange rates depending on the case.

provide (in the case of Aguas Argentinas S.A. in the form of the public recognition and transfer to prices of any modification of the peso-dollar parity) and the application of systematic price increases associated to the evolution of the United States' price index. The latter took place in a context of deflation of local prices and wages, and in spite of the explicit prohibition of price rises established in the Convertibility Law N° 23,928.

In this context situates a first thought related to what was instituted in the 8th article of the Emergency Law N° 25,561. This article eliminated the “dolarisation” of prices together with the “exchange rate insurance” and the periodic adjustment of prices previously enjoyed by the firms¹⁰⁴. In this respect, Law N° 25,561 established that “all adjusting clauses in dollars or in any other foreign currencies and all the adjusting clauses based in price indexes from other countries and any other adjusting mechanisms are eliminated. The prices and tariffs resulting from those clauses, are now expressed in pesos at the exchange rate of one peso = one dollar”.

The elimination of the particular privileges of these firms is reinforced with the reformulation of article 10th of the Convertibility Law. In this respect, article 4th of Law N° 25,561 confirms (in the same direction as previous judicial judgements) that the price-rise prohibition operates since April 1st 1991. The reformulated text of article 10th of the Convertibility Law is written as follows: “All legal or regulatory norms that establish or authorise the price indexation, monetary adjusting, cost variation or any other way of increasing debts, taxes, prices or tariffs of goods, works or services are kept eliminated *since April 1st 1991*” (own italics). This seems to make viable the

¹⁰⁴ The concessionaire Aguas Argentinas S.A. enjoys a peculiar form of income “dolarisation” since February 1st 2000, which differentiates it from the other privatised firms. In effect, in other cases (telecommunications, electricity, natural gas, highways and some national routes), the “dolarisation” of prices emerges as a previous step to the adoption of a legal device to avoid the Convertibility Law. Because nothing is said in the Law about the currency for which the price-rise prohibition applies, it is assumed that it refers to prices and tariffs expressed in the local currency (therefore, it is enough to express them in any other currency -such as the dollar- to be exempted from the prohibition). In the case of the water and sewerage service, there was no care to comply with what was established in the Law. Prices continued expressed in pesos, and having completely ignored the dispositions of the Convertibility Law, they were adjusted following the variation of the United States' price indexes.

revision of all those price adjustments that, through Decrees and Resolutions of doubtful legality (as in the case of the concession to Aguas Argentinas S.A.), have permitted the appropriation of extraordinary profits by the private firms that operate the public utilities.

A second thought refers to what was instituted by the article 9th of Law N° 25,251, which sets the renegotiation of the leasing contracts with the private firms. One of the distinctive characteristics of the Argentine privatisations (particularly that of the water and sewerage system) has been the recurrent and opaque renegotiation of the leasing contracts. In general, these renegotiations were linked to price rises, atypical price revisions and/or the incorporation of new fixed charges to users and consumers of the service, pardon of the firm's failure to comply with investing commitments and new privileges. However, Emergency Law includes, as an original fact, some basic criteria on which those renegotiations should be structured. These criteria have little to do with those that had supported the previous renegotiations of some leasing contract clauses. In particular, Emergency Law establishes that the renegotiations should consider “the impact of prices in the competitiveness of the economy and the distribution of income; the quality of the services and the investing plans, when they were considered in the leasing contracts; the consumers' interests and the accessibility to the system; the security of the systems; and the profits of the firms.”

The effects of prices on the competitiveness and the distribution of income¹⁰⁵ were taken into account. Also considered were the highly unsatisfactory degrees of achievement of quality standards and investing commitments, the exorbitant (not at all “just” or “reasonable”) profits of the firms, the lack of protection of the consumers' interests and the lack of concern for service universalisation and security in service provision (in fact, insecurity prevailed in many areas). This emerges as new and very legitimate fact in what concerns to the protection of the whole society in view of

¹⁰⁵ Undoubtedly, in the case of the water and sewerage system, the most negative effects accumulated during the nineties as a result of the way in which the privatisations and later renegotiations were done, go well beyond the income distribution matter and affect the quality of life and the health of the population (specially that of the lowest income groups).

previous official permissiveness to -and/or capture by- the privatised firms¹⁰⁶. In other words, those basic criteria on which the renegotiations will be structured emerge as essential components, of enough weight, to allow the Executive Power to incorporate them in the table of negotiation with the private firms in general and particularly - following the considerations done in the central body of this paper- with Aguas Argentinas S.A..

On the other hand, contrary to what happened in the previous renegotiations that systematically tended to preserve -or even increase- the profits of privilege of the privatised firms, consideration to their profits should refer, pure and exclusively, to convert the provision of public utility services into an economic activity like any other, with the resulting economic risks. This should take place without -as happened in the nineties- the concession of guarantees -even those formalised under the usual recurrence to the “need” to maintain unaltered the economic-financial equation of the firms and/or the rate of return to capital originally planned. Moreover, consideration of the rates of profit of the firms should constitute a decisive element in the periodic revisions of prices. In the atypical local example, however, they are considered only in a few of the privatised public utilities. Also, given the characteristics of many of these services – monopoly markets, low elasticity of demand, unsatisfied demand, legal market reserves- the justice and reasonability of prices -and that of the benefits they produce- would remit, probably, as the international experience shows, to rates of return lower than those prevailing in the greater part of the remaining sectors of the local economy¹⁰⁷.

Actually, if the criteria established in Law N° 25,561 were satisfied, the results of the negotiations that are to begin¹⁰⁸ should constitute in the antithesis of what

¹⁰⁶ See Azpiazu, D.; “Las renegotiaciones contractuales en los servicios públicos privatizados. ¿Seguridad jurídica o preservación de rentas de privilegio?”, *Realidad Económica Magazine* N° 164, may-june 1999.

¹⁰⁷ Between 1993 and 2000, the mean rate of return of the privatised public utilities has been, in average, almost seven times greater than that of the firms which compose the selected group of the 200 greatest firms of the country but are not related the privatisation process. See Azpiazu, D. and Schorr, M.; “Privatizaciones, rentas de privilegio, subordinación estatal y acumulación del capital en la Argentina contemporánea”, C.T.A., December 2001.

¹⁰⁸ When this *post scriptum* was being written (mid March 2002), only a few informal meetings with some of the privatised firms had already taken place. Probably, the formal work of the Commission of Renegotiation with all the privatised firms will start in the second half of March.

happened in the precedent renegotiations. The prevailing orientation in those renegotiations was to systematically maintain or increase the extraordinary profits of the privatised firms, against the legal security and the real interests of users and consumers of privatised public utilities.

The third thought is probably the most transcendent in what concerns to the form that the present renegotiation of the leasing contracts will take. It refers to the consideration of the relation of power that will finally be reflected in the results of this process. Questions in this respect arise from the historical lobbying power of the privatised firms, which is articulated and complemented with the no less evident one exerted by some of the members of the Executive and Legislative Power. Also, the systematic use -since the sanction of the Law- of the traditional media operations -even threatening one- and specially, the pressure exerted by the highest national authorities of many countries from where the private firms come -even up to an unscrupulous degree, as transcended in the media-. They all lead to greater doubts about the definitive way in which the renegotiations that are about to start will actually end up.

7. III. PUBLIC INSTITUTIONS IN THE RENEGOTIATION AND AGUAS ARGENTINAS OFFENSIVE

On the basis of what was established in article 8th of the Emergency Law, during February 2002 Decrees N° 293 (February 12^{ve}) and N° 370 (February 22nd) were sanctioned. The former assigns the National Economy Ministry “the mission to conduct the renegotiation of the contracts”, reaffirms the basic criteria that should guide the renegotiation and creates the Renegotiation Commission that will assist the Ministry. On the other hand, Decree N° 370/02 establishes the way in which the mentioned Commission will be conformed. It also invites the Representative of People’s Interest to participate and includes a member of users and consumers associations in the Commission. Also, it is important to note that this norm establishes that “the agreements reached or, on the contrary, the recommendation to cancel the leasing contracts will be subscribed by the National Economy Ministry, ad referendum of the Executive Power, after which they will be forwarded to the Monitoring Commission of the Two Chambers of the Parliament”, created by Law N° 25,561.

Anyway, in the interregnum that separates the sanction of the law and the creation of that Commission (which, among other missions has to renegotiate the leasing contract for the provision of water and sewerage services), the firm Aguas Argentinas S.A. started an aggressive policy of pressure on the national authorities tending, naturally, to preserve -or increase- the firm's privileges and extraordinary profits. In this sense, Note N° 35.050/02, with the signature of the president of the firm (Juan Carlos Cassagne) and the Adjunct General Director (Carlos H. Ben), was forwarded to the Sub-secretary of Hydric Resources, on January 30th 2002. Before highlighting some of the "exigencies"¹⁰⁹ which emerge from the mentioned note, it is important to stress on, probably, its most transcendent fact: the imperative and threatening tone which underlies all along it.

Before referring to some of the main "impositions" by Aguas Argentinas S.A. faced to the beginning of the renegotiation of the leasing contract, just a short digression. On February 25th 2002 -once the mentioned decrees were publicly known-, Aguas Argentinas S.A. higher representatives, Michel Trousseau and Juan Carlos Cassagne, together with the France ambassador for Argentina, Paul Dijoud, had an interview with the vice minister of the Economy, Jorge Todesca, and the Legal and Administrative Secretary of the National Economy Ministry, Eduardo Ratti. The main objective was, as a last resort, to exert their institutional and diplomatic pressure in view of the imminent beginning of the renegotiation process.

Besides the latter digression -very much illustrative of the forms the institutional action and pressure of the firm took-¹¹⁰ it is relevant to present the most substantive aspects that emanate from the Note forwarded to the Executive Power by Aguas Argentinas S.A.. For illustrative purposes, some "dispositions" (as mentioned, it is not appropriate to refer to them as "proposals") in the Note (and the Emergency Plan that accompanies it) are next highlighted:

¹⁰⁹ As will be shown later on, it was not about "proposals" tending to a debate and agreement, but about one-sided exigencies.

¹¹⁰ Following information published in the media (in the main journals of the country, such as Clarín and La Nación on February 26th 2002), the firm incorporated, also, as a topic to discuss in the renegotiation, the extension of the leasing time (originally, 30 years).

- “The investment objectives established in the Agreement Act signed by Aguas Argentinas and the ETOSS on January 9th 2001 are *suspended*. Emergency investments that are feasible and necessary for the normal provision of the services *will be executed*” (own italics). A brief comment in this respect: following estimations done by the ETOSS in year 2001, the firm’s failure to comply with investment commitments exceeds 40% of what was projected and agreed in the mentioned Act.
- Unilaterally, several Resolutions by ETOSS (which, in general, are related to obligations of the firm to re-invoice due to price reductions to some users as a result of the previous breach of the contract by the firm¹¹¹) “are *suspended*” (own italics).
- Also unilaterally, a great variety of contractual clauses related to the essence of the leasing contract and the obligations regarding guarantees by the concessionaire, “are *suspended*”, at least up to the end of the renegotiation process¹¹² (own italics).
- “Up to the termination of the works established in article 9th, a mechanism that contemplates the price or concession cost rises, *must be agreed*” (own italics). As emerges from the previous review, article 4th of the Emergency Law prohibited the adjustment of prices by, among others, “the variation of costs”. It is obvious that, as in the previous renegotiations, the firm seems not to follow the current legislation. Precisely, in other privatised sectors (such as electricity) the regulatory body (in that case, the ENRE) frozen the prices up to, at least, the end of March 2002.
 - “... the Central Bank of the Argentine Republic *will sell* dollars to Aguas Argentinas S.A. at the parity one peso = one dollar to guarantee the payment in

¹¹¹ Such as, for example, lower than minimum pressure, suspension of intimations of payment and service cuts to “the clients to which the firm omitted to apply the price reduction established in Resolution 29/99”, etc.

¹¹² This is the case of, among others, the obligation to maintain a minimum capital of 120 million dollars in cash, which cannot diminish during the operation of the leasing contract; the obligation to give sufficient guarantees to the nation to ensure the payment of the debt services, to cover the risks of penalties, damages, tax obligations, insurances, etc.. This guaranty is executable in the case the concessionaire is guilty of the extinction of the leasing contract, which can be adopted unilaterally by the National Executive Power in the following situations: lack of constitution, renewal or reconstitution of the Guaranty of the Contract or the insurances established; bankruptcy, liquidation without bankruptcy or dissolution of the society, preventive concourse of creditors, and the encumber

time of short and long term debt services that were taken with National and International Banks, as well as with Multilateral Organisms” (own italics). Before highlighting the effective implications of this new exigency, it is important to note that according to the last balance of Aguas Argentinas S.A. its external debt ascends to 672 million dollars. In strictly economic terms, this is the “exigency” of a privilege that should be characterised as more than inappropriate. As an exchange rate insurance with retroactive effects, it could also be considered extremely unusual. In this respect, it is important to highlight that during the time in which this Post Scriptum was being written, the peso-dollar parity had stabilised little above two pesos per dollar. This would imply that the State (in fact, the society as a whole) should bear more than half the firm’s external debt. On the other hand, as mentioned in the main body of the paper, that external debt was a privileged instrument enjoyed by the firm to finance its delayed investments. This fact has to be articulated with other two peculiarities of the economic and financial strategy the firm has been developing in the country. On the one hand, it systematically minimised the contribution with own resources and, on the other hand, it took advantage of its privileged access (in terms of time period and interest rate) to the external markets (in favour of the firm’s relation with external creditors and the firm’s performance, as reflected in its extraordinary rates of return). It should also be remembered that, as mentioned before, the coefficient of total liabilities / net worth of the firm ascended, at the end of 2001 to 2.49 whereas in the original bid it was planned that that coefficient would not be superior to 0.80.

The fallacious argument that lays beneath Aguas Argentinas’s position (although not explained in the Note) is that the firm’s external debt was directed to finance investment in the country. Again, at least three digressions apply. Firstly, the same could be argued by absolutely all the local firms (privatised and non-privatised, large, medium or small industrial or agricultural firms) as well as by any argentine person that has borrowed money from abroad. Secondly, given the magnitude of the

of the guaranties of payment in their favour, which make impossible the compliance with the leasing contract.

resources that Aguas Argentinas S.A. has remitted abroad in concept of distribution of dividends, as well as through purchases to controlled or linked firms (without any control on the probable implicit transference prices), which ascends to more than 550 million dollars¹¹³, it is even more surprising that they demand an exchange rate insurance with retroactive effect. Thirdly, the decision of borrowing abroad (with the consequent risks -and, in another time, the benefits, given the preferential rates of interest they obtained, specially if compared with the domestic ones) it is a private decision of a microeconomic strategy that has no reason to include, lately, a compensatory state subsidy -of almost 700 million pesos (or, around 350 million dollars at the present exchange rate).

On the other hand, always circumscribing the comments to the financial aspects, the firms does not mention an extraordinary benefit that it internalised in the frame of the dispositions of the same Emergency Law and the devaluation of the currency: the “evaporation” of a substantive part of its debt with the local financial system¹¹⁴. Following information from the Central Bank of the Argentine Republic, in September 2001, Aguas Argentinas S.A. local debt ascended to 117.4 million dollars). Considering the one dollar = two pesos parity, the liabilities that Aguas Argentinas S.A. got “evaporated” (that is, transferred to the Argentine society) ascended to around 60 million dollars.

“The Secretary of Industry and Commerce, the Central Bank of the Argentine Republic and every public office that should intervene in the import of: bauxite, aluminium hydroxide, sulphuric acid, sulphur, meters; ... *should* give priority to the administrative arrangements involved and to its approval so that it can be rapidly acquired at the one dollar = one peso parity” (own italics). Again, this means an exclusive exchange rate insurance for the firm, in a way so that it does not effectively suffer the effects of currency devaluation. In this respect, and besides

¹¹³ Lentini, E.; “El impacto en la concesión de agua y saneamiento del Area Metropolitana. Un análisis preliminar”, I.A.S.P., *Seminar “Los servicios públicos en el nuevo escenario económico”*, ETOSS, February 2002.

¹¹⁴ Originally, Law N° 25,561 dictated the “pesificación” (at a parity of 1 dollar = 1 peso) of debts up to 100,000 dollars. Later on, and as a result of the pressure exerted by large firms locally indebted in dollars (among them, Aguas Argentinas S.A.), Decree N° 214/02, extended that “pesificación” to debts of any amount.

what was previously pointed about the high component of the intra-corporative purchases in the cost structure of the firm, it has not followed the local legislation - with the compliance of public regulatory offices. Specifically, Aguas Argentinas S.A., as the greater part of the public utilities privatised firms¹¹⁵, has not complied with Law N° 5,340 (Local Buy) nor with N° 18,587 (Local Leasing), in what regards to the call for public tendering and the obligation to compare the local firms' bids with those of foreign firms of the same kind.

Moreover, besides any consideration regarding the failure to comply with local legislation, the process of appreciation of the local currency in the context of the opening of the economy that took place during the nineties, has encouraged the gradual substitution of local resources for similar imported ones. Aguas Argentinas S.A. is not an exemption in this respect, especially when a great part of its suppliers from abroad are firms controlled or linked to the conglomerate that controls it (Suez Lyonnaise des Eaux-Dumez). This implies the possibility of recurring to transference prices in those transactions and, in this way, implement different types of mechanisms of tax evasion locally. In synthesis, this new and immoderate "demand" of the firm lacks the minimum argumentative support, in strictly economic as well as juridical aspects. It is the obstinate recurrence to demand privileges to whom –as comes out of the main body of the document as well as of this *post scriptum*- has been transgressing a large spectrum of legal norms, in detriment of the interests and life conditions of water and sewerage users and consumers of the Buenos Aires Metropolitan Area.

¹¹⁵ In this respect, there are a few known judicial judgements against diverse privatised utilities' concessionaires (such as Metrovias S.A. -underground and a freight services branch line train-; Autopistas del Sol S.A. and Autopistas del Oeste S.A. -both highways concessionaires- and Tren de la Costa S.A.), as well as diverse judicial denounces against Aguas Argentinas S.A..

8. *IV. SHORT FINAL CONSIDERATIONS*

Even if it is generally a common practice in any negotiation that both sides adopt extreme positions at the beginning, the content of the Note forwarded to the National Executive Power by Aguas Argentinas S.A. and, specially, the imperative, authoritarian and quasi-blackmailing tone it denotes, seems to largely exceed the simple characterisation of inappropriate. Moreover, it could even be interpreted that the intention of Aguas Argentinas S.A. to renegotiate the leasing contract and/or some of its essential clauses is, at least, weak. As many of those clauses have permitted the firm internalise extraordinary benefits in a context of systematic failure to comply with commitments agreed in the leasing contract. On the other hand, it emerges from Aguas Argentinas S.A.'s Note that the firm completely disregards the economic emergency, to which it has contributed during the nine years of administration.

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