

Water Companies for Sale: What is the State's Role?

The State is not summoned to provide goods and services which the private sector can produce in a more efficient way. In this and other cases, privatization serves the interests of the final customers and the public treasury, who can thereby liberate resources and allocate them to other purposes requiring its investment.

The government announced the sale of its minority interest in the water companies Aguas Andinas (34.98%), ESSAL (45.46%), ESVAL (29.43%) and ESSBÍO (43.44%). This has caused great commotion among public opinion, despite the fact that it had already been announced both in the Government Program and the 21st May speech of President Piñera, and also during the debate concerning the funds collection for the country's reconstruction after the earthquake.

Regardless of this specific case, it seems interesting to take up again the discussion on the role that the State must play in the country's productive activity. Although currently this is a subject that fortunately very few people question, since the private initiative has been globally recognized as beneficial, there is still an ideological discussion regarding certain basic service areas, such as water, where certain people call for the necessary presence of the State. In this context, it is propitious to ask ourselves: What have we learned from our own experience? Which should be the role of the State if we want to reach the standards of a developed country?

Historical Background

The Chilean economic history of the last eight decades talks about a varied experience concerning the State's participation in the productive activity. In fact, the Great Depression of the thirties had a

severe impact on the Chilean economy. The existing economic model, oriented towards the export of natural resources and *laissez-faire* policies, gave way to a domestic-oriented development model. It was sought to increase industrialization based on import substitution as the prevailing formula for economic growth. The relatively slow reaction of the private sector and the perception that it was necessary to develop key sectors of energy and intermediate supplies for the development of the import substitution industry, led to a gradually increasing role of the State in the economic process since the thirties.

The Corporación de Fomento y Producción (CORFO) was created in 1939 in this scenario, with the purpose of formulating a national development program and the allocation of resources for productive activities included in this program. CORFO became the main growth promotion instrument. It created the biggest state-owned companies in the basic industrial intermediate sectors, such as ENDESA in 1944, CAP in 1946, ENAP in 1950 and IANSA in 1952. During the period 1939-1973 it was in charge of direct investment in public companies and credit allocation. Additionally, there were companies created by Law, such as ECA, ENAMI and LAN, and other companies were nationalized, sometimes without compensation (CODELCO), or otherwise they were taken over, expropriated or illegally seized by the workers.

Consequently, between 1940 and 1970, the State took an increasing role in the productive process, passing from a State which promotes private industry to an entrepreneurial State and, finally, to a programming State which defined the long-term development strategies.

The process culminated in 1970 with the socialist project, which sought to replace the private property of the means of production by the state ownership. As a matter of fact, in the following three years a quick transformation towards a state ownership of the means of production was carried out, and at the end of 1972 the State had reached a size as yet unknown in the country's economic history.

In brief, successive governments had accumulated productive assets which in 1973 produced 30% of the GDP and were distributed among 596 companies; these figures include neither the infrastructure or services such as education, health and housing, nor the agricultural properties. There were sectors monopolized by state-owned companies or the presence of the latter was dominant in other

sectors. In particular, in 1973, 85% of the mining industry, 40% of the industry, 100% of the public services, 70% of transport and communications and 85% of the financial sector were controlled by public companies. Many of these companies were not profitable; they required significant transfers of fiscal resources and had privileges which were not shared by private enterprises. Companies' inefficiency and bad service were becoming generalized.

Table 1

STATE-OWNED COMPANIES' INTEREST IN THE PRODUCTION
ACTIVITY
(STATE-OWNED COMPANIES AS % OF THE SECTORAL
PRODUCTION GROSS VALUE)

	1965	1973	1981	1989	1998
Mining	13	85	83	60	45
Industry	3	40	12	3	3
Public Services	25	100	75	25	20
Transport	24	70	21	10	5
Communications	11	70	96	0	0
Financial	-	85	28	10	10

Source: Hachette, D. (2000) Privatizaciones: Reforma estructural pero inconclusa. La transformación económica de Chile. Chapter 4.

Since 1973, the collapse of the government of the Unidad Popular produced a reversion of the economic model. The new model emphasized productive offer, giving a priority role to the market as a resource provider, while the State assumed a subsidiary role.ⁱ Thus, the State played a minimum entrepreneurial role, except in those companies considered strategic or crucial to the country. It was thereby initiated a transfer process of the companies owned by CORFO and the return of the companies which had been requisitioned or taken over.

The privatization process of public companies and the stimulus to the private activity started in 1974, and continued after the return to democracy in March 1990. In fact, the privatization process was extended to areas such as the sanitation services and the construction of road infrastructure was encouraged through private company leases.

Notwithstanding the foregoing, important state-owned companies still exist in Chile (such as CODELCO and ENAP); we have not yet

reached the necessary consensus regarding the need to progress towards a less entrepreneurial State.

The current government has decided to give some additional, although minor steps in this activity transfer process to the private sector, with the sale of dispensable assets which are still in the hands of the State, such as the water companies, where it maintains a minority interest. The sale process is being discussed in a context where it seems legitimate to question what justifies the presence of the government in the current companies. The substance of the debate is if it is positive for the State to hold a minority interest in these companies and if we gain something with its presence.

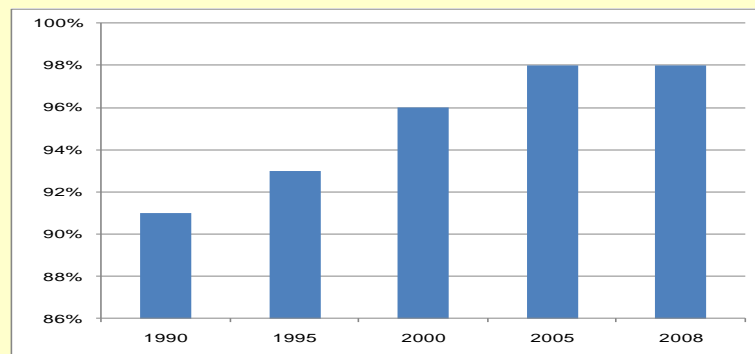
Currently State-owned Companies

Besides the role of the State in CODELCO and ENAP, there are 25 additional public companies whose control is exercised by the System of Public Companies (SEP, in Spanish). These enterprises cover different sectors, such as port infrastructure, water companies, urban and interurban terrestrial transport, and services in productive sectors such as mining and agriculture. We should also add the minority interest which CORFO holds in Aguas Andinas S.A., ESSBIO S.A., ESVAL S.A. and ESSAL S.A.

With regard to the water companies, it should be mentioned that EMOS and ESVAL were created as public companies by the Law 18,777 of 1989, while others, such as ESSBÍO, were created under Law Nr 18,885. Law Nr 19,549 of 1998 adopted the resolution to release the restrictions to the transfer of the State's shares in these companies in order to sell them to private entities, although it established the obligation to keep at least 35% of the ownership in the hands of the State. Later on, Law Nr 19,888 of 2003 eliminated the regulations (contained in Laws 18,777 and 18,885) which established the requirement to keep the minimum 35% of the water companies; therefore, today it is possible to freely dispose of the shares owned by the State in these water companies.

Chart 1

CHILE: URBAN POPULATION ACCESS TO SANITATION FACILITIES



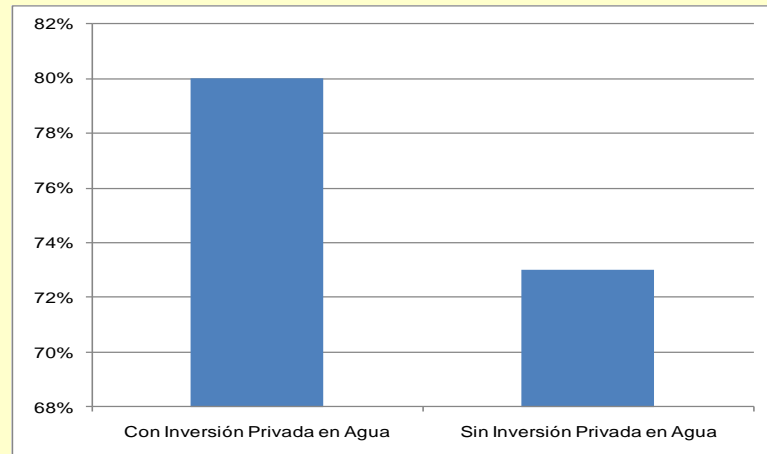
Source: World Bank

This is certainly the appropriate thing to do for a society which recognizes that the State should only perform entrepreneurial activities when the private sector does not want to or is unable to develop them, always trying to return them to those who are naturally concerned, thus fulfilling its role of subsidiary State at the service of individuals, and not vice versa.

Nevertheless, the announced sale of the minority interest in water companies does not represent a privatization, insofar as this already occurred at the end of the nineties when their majority interest was sold, and which meant to transfer their control and management to the private sector. This decision revealed substantial benefits for the country, because it encouraged a strong investment process in the sector which allowed increasing the services coverage concerning drinkable water and sewage.

Chart 2

ACCESS TO CLEAN WATER IN DEVELOPING COUNTRIES



Source: WDI online, quoted in Segerfeldt, F. (2005). *Water for Sale*.

This does not differ much from the situation of other developing countries. According to Fredrik Segerfeldt, in his book *Water for Sale* (2005), 95% of the water distribution in the developing countries was managed by the public sector, which was therefore responsible for the fact that more than one billion people had no access to water. This situation has led several governments to look for help through private capitals, which in general had positive outcomes. In fact, in poor countries where private investment has been incorporated to the sanitation sector, a higher population proportion has managed to have access to clean water, compared with countries which have not incorporated private capitals. This has been the result of the competition increase, better incentives and greater access to capital, which has allowed improving the quality and coverage of water distribution.

The national and international experience confirms that the results obtained with the incorporation of private investment to the sanitation sector are considerably higher in relation to the access to sanitation facilities. Therefore, even if the drinking water supply and wastewater treatment represent a first necessity good which must be guaranteed by the State, it is not a requirement for the State to produce it. On the contrary, time has demonstrated that the private sector can do it not only more efficiently but also pumping important resources for the

investment in this sector, allowing the State to allocate resources, which are always scarce, to other purposes of high social profitability.

It is also important to confirm that the overall sale of the sanitation assets does not represent any inconvenient from the point of view of the final customers, as argued by those who are opposed to their transfer. Actually, the profits of the water companies and the high prices that consumers would have to pay are under discussion. However, if there are doubts as to how the private sector will behave once it owns 100% of the water companies, then the important thing is to improve regulation, and not to keep the State's ownership. The fact that the State remains in the companies does not assure the user's protection, but only guarantees that the State also participates in the earnings of a bad regulation.

Anyway, it is highly relevant to note that the institutional framework which regulates the water companies, especially in charge fixing matters, has properly operated and is fully consolidated. This guarantees that the interests of the final customers will be safeguarded.

Moreover, the idea of the government of Chile of selling the State's remaining interest in the water companies is in line with the arguments which motivated the revocation of the 35% regulation, which is to finance the main government's social goals. The water companies concerned generated dividends for CORFO which amounted to US\$112 millions in 2010, equivalent to 7.8% of the organism's total incomes. With an adequate sale process, it is estimated that the disposal of CORFO's minority interest in the water companies could generate resources between US\$1,400 and US\$1,800 millions.

The government announced that the resources coming from the sale of the remaining ownership interest in water companies will have the following priorities: (i) to strengthen the assets of certain public companies which need capital to expand their operations, such as Metro, Metrotren Valparaíso, the transport system of Concepción and EFE; (ii) to strengthen CORFO's funds in order to directly benefit the small and medium enterprises (Pymes); and (iii) to finance the big reforms, such as improving the quality of education, health, citizen security and housing.

With regard to the proposed objectives, it is important to remember that, even if it is not justifiable for the government to have interests in

the water companies, it does not mean that it must sell them no matter what the purpose is. In particular, this decision must be taken if there is a higher alternative benefit and, in this perspective, the remaining ownership disposal must be understood as the necessary financing to guarantee the government's social goals, where we can find greater benefits than those generated by these companies.

Therefore, the recently announced sale is totally justified if it means to redirect the resources towards activities of greater social profitability and whose access to the capital market seems restricted. In this context, the capitalization of public companies – such as Metro and EFE – does not appear to be the right destination, since they could obtain resources in the financial market at attractive rates depending on the projects' profitability. To associate the sale of the water companies to the purpose of obtaining resources for certain public companies is an inappropriate argument, which only recognizes the problem of enterprises like EFE (due to inefficiency) to get resources from the financial market.

Instead, the case of initiatives associated to education and citizen security, among others, is very different; their social returns are extremely high, even if they do not rely on enough resources, a fact which justifies the advance of public funds for these purposes.

Conclusions

The higher or lower participation of the Chilean State in the last eight decades allows drawing certain conclusions. The role of entrepreneurial State, which gradually increased throughout four decades (until 1973), gave birth to a weak economic development. With the liberalization started in 1973, the private entrepreneurs left behind their passivity and State-dependence in order to become active and autonomous agents. This originated a resources reallocation towards more competitive sectors and the different economic sectors gained more efficiency, which has directly benefited the society. This is the case for the traditional productive sectors and also for those considered of first necessity or strategic value.

Therefore, it is important to highlight that the State is not summoned to provide goods and services which the private sector can produce in a more efficient way, since its privatization serves the interests of the final customers and the public treasury, which can thereby

liberate resources and allocate them to other purposes requiring its investment.

In this context, the decision to sell the minority interest still owned by the CORFO in the water companies is absolutely adequate. Especially if it allows the government to transfer resources which represent today a passive financial investment towards activities whose social profitability is higher, but where it is impossible to obtain resources in the financial market.

ⁱ The role of the State would be theoretically restricted to the provision of public goods and to correct the market's deficiencies.