
Selected Issues of Utility Policies in Budapest

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This paper offers a short overview of some issues of the new utility policies introduced in the Municipality of Budapest during the 1990s (i.e. the first decade of the Transition). Three policy areas are selected: (1) the user charges for utilities, (2) the system of social subsidies to charges and (3) the privatization of utility companies. The selection of the topics is based on two considerations: (1) they are all crucial elements in redesigning of policies during Transition and (2) they are utterly interdependent.

In 1990 in Budapest the newly elected municipal leadership inherited the utilities from the former socialist period. Socialist infrastructure development policies of utilities were clearly supply-driven (i.e. the “predict and provide” method) resulting in large networks, in often inappropriate design and deteriorated quality of assets due to postponed maintenance. At the same time charges for utility services were very low, often resulting in frivolous consumption, not supplying cost coverage for the service and causing low accountability of providers. The symbolic charges users paid meant massive subsidies for all social layers.

In the early 1990s the responsibility for the service provision (in 1990), the core utility assets (1991) and the price setting authority¹ (1994) was allocated to the local governments in Hungary. By 1996 all municipal utility companies were corporatized in Budapest. Today the municipality sets the charge level, each company collects the user charge revenue of the related service and, in some cases, receive subsidies. The companies sign a Service Delivery

¹ This is true (i.e. price setting authority) for all utility services mentioned in this paper with the exception of the gas. Pricing of the energy sector was maintained at the central government level.

agreement with the Municipality each year and from the revenues collected they must run the services included in the agreement. The system of social subsidies for people who cannot afford the charges was established and is ran by the municipality, but financial contributions are paid by the companies.

During the Transition period the challenge in the redesign of utility policies was threefold: (1) increase the efficiency of the service delivery; (2) secure financial resources for the provision of the service; and (3) rationalize consumption. The first important step in the reform process during the 1990s was the gradual increase of user charges. Increased charges had important effects both on the users and the providers. They increased cost awareness of users that in turn modified consumption patterns, increased accountability of providers and created more revenue for the service, hence furnished the conditions for improving service delivery.

Increasing cost coverage of prices gradually eliminated the general subsidization of users. At the same time, increased prices became unaffordable for the poor. A process that necessitated the introduction of targeted subsidies to maintain willingness to pay. In 1995 in Budapest the so called Compensation Fund was created to distribute aid for those who could demonstrate their inability to pay the full price. Thus considerations related to service delivery and social assistance functions got finally separated. As it will be demonstrated through the data, a small fragment of the revenue increase of the service was enough as well targeted subsidy to keep the poor in the service and maintain general paying discipline.

The separation of the service provision and the social assistance function and the decent revenue of the companies due to the increased charges had one more important effect. It rendered privatization possible. The privatization revenue supplied sources for infrastructure improvements for better service quality, while the involvement of the private partners helped to rationalize the company increasing efficiency and decreasing the unit cost of service. The transparent process and the strong competition at the privatization tender decreased opportunities for corruption.

After this short revue of the interdependence of the three issues (charges, subsidies and privatization), the rest of the paper will shortly present the Budapest experience, i.e. the events and policies, related to each of them.

USER CHARGES FOR UTILITIES

The inherited symbolic charge for waste containers were replaced by a volumetric charge for households waste in Budapest in 1996. The inflexibility of the container based volumetric charges scheme was attacked by lively criticism in the course of a few month after its introduction. Later – as the users got familiar with the new system – some 20 percent of containers were returned, and both the collected volume and charges reached a balanced level in the course of one year. The major fear before the introduction was that illegal dumping would increase, but similarly to other countries' experiences, no evidence has occurred on this matter.

Since 1997, in consequence of the charging policy, only the development expenses of waste management have debited the budget of the Municipality.

On the field of water services the socialist heritage was a relatively well-developed, but poorly maintained network of both water supply (with 97.5 percent coverage) and sewage collection network (with 90.2 percent coverage). The rate of waste water treatment, however, was very low (25 percent in 1999). At the same time, in consequence of symbolic prices, water consumption well surpassed Western European standards.

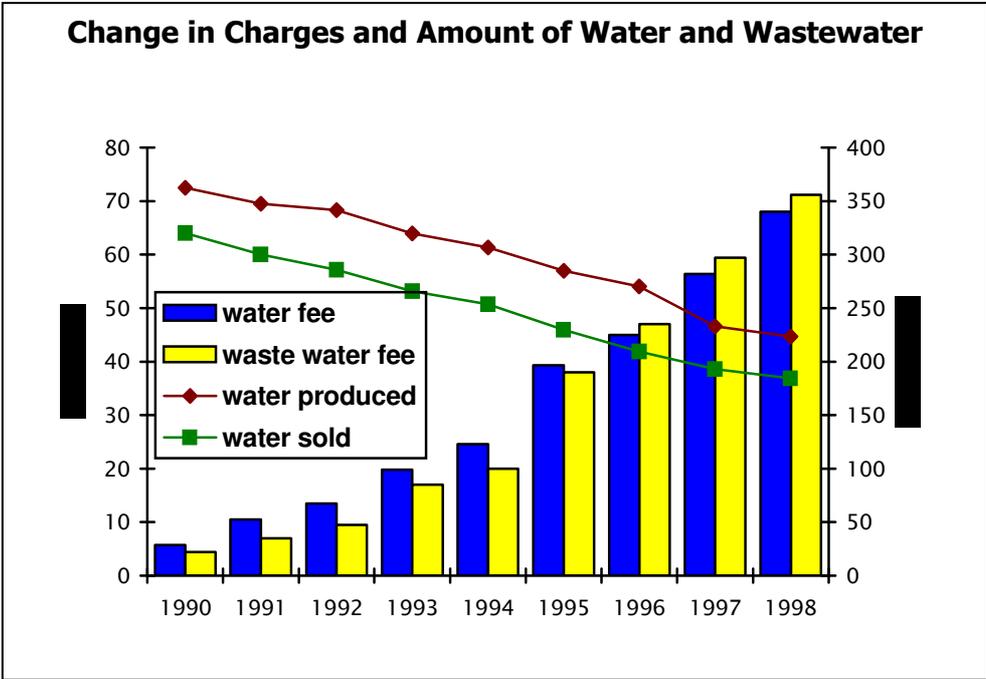
The gradual increase of user charges not only decreased household consumption by 20%, (arriving to a level similar to EU average), but allowed a nearly full cost recovery. The increase of the charges has multiple consequences: it rationalized consumption (i.e. decrease frivolous consumption), improved cost coverage² and made privatization possible.

The price increase has clearly eliminated the massive subsidy of all users by the symbolic prices. At the same time it made some services hardly affordable for some social strata, creating the need for targeted subsidies for the poor. (Description and explanation of the subsidy system can be found below)

² Water charges cover the costs, while in the wastewater system some investment subsidy is still needed. The wastewater figures, however, can not be used as comparative data due to the low share of the existing treatment capacity.

The pricing system has further changed with the privatization. Multi-part tariffs are applied for water charges. They consist of a one-time connection fee, an access fee and there is a use related charge that is calculated on a volumetric basis. The volumetric charge is based on average accounted costs determined by a cash flow based formula that is set in the privatization contract³.

Though the pricing is based on an average cost rather than marginal cost type charge, it still affected users' behavior as it can be seen in on the chart below. The present system provides for an adequate information about the demand which help introducing further rationalization steps in service delivery. The plan of the city for waste water treatment capacity development was 1.5 million cubic meter in 1993, it was cut back to 600 thousand cubic meter per year in 1999 and the process of adjustment of plans to demand continues. This process enables to save huge development costs on wastewater services and operating costs both on water and wastewater services.



³ Before the privatization the charge was decided yearly by the municipal assembly on the basis of direct accounting cost estimates prepared by the companies.

1.1 SOCIAL SUBSIDIES FOR UTILITY CHARGES

During the socialist times user charges for public utility services were very low. All citizens were subsidized by the charges kept on a symbolic level. User charges have permanently increased since the beginning of the 1990s, still the clear change in the charging strategy was decided only in the mid 1990s in the frame of the financial reforms. In 1995 drastic increase started and charges started to better reflect production costs. In consequence user charges started to rapidly approach cost recovery, but at the same time they also became hardly affordable for certain social groups.

To treat the social problem the Municipality established a Compensation Fund in 1996. All citizens with demonstrated needs can apply for aid to the Compensation Fund. The amount received depends on the social condition and income of the applicant family. The subsidy is not directly paid to the families but the due amount is automatically decreased by it.

Table 1 : The Compensation Fund

		1995	1996	1997	1998	1999
Amount paid by: (in Million HUF)	District Heating Co	250	300	400	450	450
	Water Works	125	150	200	230	260
	Waste Water Works	125	150	200	230	260
	Public Cleaniness Co		100	125	145	145
Total resources of the	Compensation Fund	500	700	925	1055	1115
Number of recipients for:	District heating		28037	28542	23991	
	Solid waste collection		36718	40028	38931	
	Water and Waste water		39003	43253	42076	

Source: Hálózat Alapítvány, Budapest

In 1999 the Compensation Fund helped 70,000 families with maximum 18,000 HUF / year for heating, 10,200 for water charges and 3,000 HUF for solid waste collection charges.

The money distributed through the Fund is supplied by the public utility companies. The company's justification for contributing to the support fund is not so much social as the need to ensure solvent demand and willingness to pay in the market. As it can be seen from the table 2 below, only a small fragment of the revenue is fed back to the Compensation Fund and experience shows that this can keep paying discipline at a good level.

Table 2 : The Compensation Fund

		1995	1996	1997
Water:	User charge revenue	8.868	10.188	12.069
(in Million HUF)	Contribution to Compensation Fund	125	150	200
Waste water:	User charge revenue	7.323	9.196	12.878
(in Million HUF)	Contribution to Compensation Fund	125	150	200
Compensated families		39003	43253	42076

1.2 PRIVATIZATION OF UTILITIES

The Budapest Municipality has concluded the privatization of some of its public utility companies. Privatization was executed according to a previously adopted concept in the framework of a transparent procedure. The concept envisioned the principal aims of privatization to be security of service and improvement of efficiency, as well as involvement of investment capital in development, improvement of service and reliance on experience of professional investors.

By adopting the **Privatization Concept** in 1994, municipal decision-makers settled the framework and procedure for 15 companies inherited from the previous political era, which were largely different in terms of tasks and operating conditions.

The concept triggered privatization in a very large circle of companies, clarifying guidelines and procedure and leaving room for future individual decisions. The individual privatization projects involved a multi stage decision-making process with assessment of major goals and specific circumstances resulting in a tailored strategy. For some companies, in which the activity has no public good character, the main goal was maximization of revenue from privatization and redressing the company's portfolio; for others involvement of capital and expertise of the new owners; or development of an organization more responsive to competition was aimed.

Basic utilities (gas, water and waste water utilities) are special among the group of public utility companies since the Budapest Municipality has regulatory and occasionally price setting responsibilities in addition to the responsibility of service provision. While these responsibilities can be easily met with the ownership but they put the Municipality in a

threefold and mutually contradicting role: the Municipality's public authority role requires neutrality in regulation; the authority to set prices calls for realistically low rates; and its proprietorial function motivates it to implement "selfish" corporate interests. In this situation, approval of the Privatization Concept can be considered as giving priority to regulatory and price setting functions whereas the proprietorial role, which in some decisions can contradict to the other two functions, can be diminished in terms of its consequences.

1.2.1 Privatization of the Three Major Utility Companies

The most important transactions in Budapest have been the privatization of the Gas Supply company, the Water Works, and Waste-Water Works. There are two common features in the privatization of the three major utility companies. First, each of them were tendered in two round open international competitive bidding process. Second, the municipality has retained its majority ownership stake in each of these companies. Third, the privatization involved the companies' core assets (the physical network and structures) in order to maintain the unity of the assets and operation. An exception from the latter principle is the case of the new sewage treatment facilities. These new components of the municipal infrastructure are ruled to remain in 100 percent municipal ownership (as an obligatory rule for assets co-financed from earmarked state grants) and are operated by the privatized company on the basis of a lease or an operation agreement.

Table 3: Privatization of Utilities

	Gas Works	Waterworks	Wastewater Works
Conditions to be fulfilled	operation & maintenance	operation & maintenance + reconstruction	operation + maintenance + reconstruction + development
Market position	monopoly	monopoly	Monopoly
User charge set by	central government	municipality	Municipality
User charge formula	none	cash-flow basis	cash-flow basis
Subsidy	none	none	Development subsidies
Privatization method	50 % in preference shares + dominant management rights	27 % of voting shares + dominant management rights + responsibility of operation	25 % of priority shares + dominant management rights + responsibility of operation
Privatization revenue	HUF13.5 bill. (1995) HUF4.3 bill. (1995) Combined USD142 million	HUF 16.5 billion (1997) USD88 million	HUF16.9 billion HUF (1997) USD88 million
Period of contract	indefinite	25 years	25 years
Investors' benefit	dividend	management fee	dividend priority
Local govt. benefit	dividend	Cost savings	dividend earnings

Source: Budapest Municipality

Besides similarities, the differences between the utility companies justified the application of differing privatization models. The Gas Company was essentially in an good condition at the time of privatization, so investors were called to submit two bids each: one for a majority, and one for a minority ownership. The decision whereby a minority shareholdings was sold with majority management rights was essentially political. A professional investor (VeW Ruhrgas consortium) was awarded the contract, which assured the enhancement of the company's efficiency. Privatization, nonetheless, should be regarded as a financial investment, whereas the market price of the shares sold depend on the gas price. Since the gas price is regulated by the central government; the Budapest local government could not offer a rate of return guarantee to the investor. The investor receives dividends only if this company is profitable under these conditions.

Although divestiture to a minority municipal ownership is still not on the agenda, it is in principle an alternative. For this reason, the local government changed the statute of the company prior privatization, and created a so cold "golden share", which will be retained even if virtually all the shares sold, because the golden share enables to retain key ownership rights (e.g. vote against closure, spin off, merger, change in the company's core activities or capital).

The Waterworks had a current and a forecasted future deficit at the time of its privatization. Therefore, the investor was not interested in acquiring a majority ownership stake, instead sought after another way of earning its profit. The investor (Suez Lyonnaise des Euax & RWE-Acqua GmbH consortium) acquired 27 percent of voting shares and a 25 year concession to be the operator of the company under a management fee agreement. The investor were enabled to obtain its profit from 75 percent of the cost saved. Cost savings is calculated on the basis of the 1996 costs according to a formula set in the contract.

Privatization of the Wastewater Works likewise did not ensure adequate return on the shares acquired. This company was a profitable sufficient to enable reinvestment for needed development. Therefore, the profit on investor's return on equity was projected to remain very low for years. As a result, the investor (CGE/Berliner Wasserbetriebe) received a priority dividend right, which means that all profits up to 18 percent of the face value of the shares purchased must be paid exclusively to the investor; and additional payments if any can only be made above this amount in proportion to the share ownership.

1.2.2 The Privatization Benefits for the Municipality

In Budapest while deciding the conditions of the transactions the improvement of efficiency vs. amount of revenue was the major trade off for the decision makers. Revenue receipt was crucial because central transfers were seriously decreasing in a period when fast reconstruction of the degraded and partly underdeveloped infrastructure was a major strategic task for the better competitiveness of the city. It was clear that capital revenues from privatization could cover (at least partly) these needed capital expenses. High revenue could be obtained from the sale of monopoly shares and more lenient conditions. In the trade off in Budapest the goal of revenue was inflated by the efficiency improvement criteria as the tender offers were evaluated with high priority put on the offer for the long term pricing mechanism⁴. Besides this element for efficiency improvement there was also a "special deal" for the same objective: in relation to the property share, increased management rights (Gas Works) or rights and responsibilities of the operation (Water and Sewage) were given to the investor as part of the contract, with the aim to increase efficiency by the rational private like management as well.

Even with high priority put on long term efficiency through the pricing formula, considerable one time capital revenue could also be obtained from the transactions. Between 1995 and 1997, privatization revenues amounted nearly USD320 million that represented on average 7 to 20 percent of municipal annual revenues in the respective years. Since 1990, the municipality uses capital revenues strictly for capital expenditures, thereby avoids living up its wealth. Privatization revenues though constitutes one-time resources, their availability was a cardinal element of infrastructure development and upgrading the city's competitiveness.

In retrospect of 3-4 years of the Budapest privatization a few weak points of the transactions are revealed by the continuous debate on some contractual arrangements⁵, still by a general evaluation, the whole process seems to be successful and to reach results⁶.

⁴ In areas where the Municipality is the pricing authority, pricing was a key issue in the privatization scheme. This means that all candidates had to make an offer both to the price of the shares, and to the rate of service to be calculated by a given formula. The inclusion of the formula of service rate offers, is aimed to replace later market regulation of price. In the case of water and sewage services, cash-flow type rates are applied, which are not only calculable, but also take into consideration costs of long-term investment in addition to operating costs and are thereby hoped to eliminate the negative incentive in respect of changes which only pay off in the long term.

⁵ Especially around the management fee of the Water Works.

In the privatization contracts of the three major utility companies, the municipality remained responsible for control, monitor, and regulate the service delivery in accordance with the Act on Local Government, and retained part of the ownership rights. Ownership rights are exercised through delegated members in the board of directors, in the supervisory boards, and at the companies' general assembly. At the same time, the companies' management has become more independent, while the Municipality, itself hardly suitable for monitoring and providing incentives⁷, acquired a purposeful and efficient partner in the private investor.

Nevertheless, separation of roles has not been entirely solved. The Budapest Municipality continues to be a majority owner, which perpetrates the conflict of roles, although on a smaller scale. Some of the resources generated by the Municipality as a compensation for public utility rates is still contributed by the utility companies. In other words, involvement of new owners has not solved the problem of completely separating social considerations from operational issues. Although it is an improvement in this set-up, that the social aspect is no longer inherent in the price, but appears as a separate targeted support. (see below in details) An explanation for this situation is that subsidized rates are aimed at avoiding the deterioration of willingness to pay, therefore, the company's justification for contributing to the support fund is not so much social as the need to ensure solvent demand and willingness to pay in the market.

There can be another special benefit of privatization during the transition listed beside the above mentioned points. The change in ownership can make the process of real inner restructuring of companies safer, as the inclusion of the private partner means the establishment of hard budget constraints and a clear commitment to rational, interest based functioning in the future. In transition especially, the symbolic content of the change in ownership can also have an importance⁸ in the process of the restructuring of the company.

⁶ As a saving deal is also part of the contract in the Waterworks which calculates the efficiency increase by a pre-set formula compared to the base year of 1995, it can be used as an indication of the results.

⁷ One of the main reasons for the inability of public agencies to motivate their staff to more efficient work is the limitation of the so-called fiduciary responsibility (limited incentives, the obligation of justification, etc.). Management of public funds imposes a substantial constraint on efficient human resource policy.

⁸ An interesting example can be taken from the Budapest Municipality to this point. It is that faced with the coming privatization the management of the Gas Company suddenly realized that a new, profit-oriented era will start in the company's life and started to push for repayment of – since many years -outstanding credits by the increase of capital, that finally happened on 9th February, 1996.

The Budapest case also contests that the importance put on privatization revenue does not necessarily invalidate efficiency increasing goals when the weighting of the trade off is prioritizing the latter. Real financial gain come to the municipality anyhow only from the increase of efficiency⁹. In Budapest the efficiency gain is monitored.

The most important message of the privatization cases in Budapest might be that not the elements of the trade off, but the fulfillment of the goals through the prioritizing of objectives in the decision process, are of crucial importance.

In Budapest the asset and management right sale to private investors was not only a revenue source for the local government, but it also meant a strong commitment for the restructuring of the companies into to efficiently functioning, business like enterprises. This was a firm step to cut the old links and networks inherited from the socialist period and start to work by new sets of rules.

Further reading:

- Ebel – Simon (1995): *Financing a large municipality: Budapest*, in: Decentralization of the Socialist State, ed: Bird - Ebel – Wallich, The World Bank
- Ebel – Várfalvi – Varga (1998): *Sorting Out Intergovernmental Roles and Responsibilities*, in: Bokros – Dethier: Public Finance Reform During the Transition: The Experience of Hungary, The World Bank
- Pallai (1999): *"Privatization of Public Utilities in Budapest 1994-1998"*, Municipality of Budapest
- Pallai (2001): *"Local financial management reform: The case of the Municipality of Budapest"*, In: Sub-national Modernization Challenges, The World Bank, (in print)

⁹ Distinction should be made between the resulting revenue from privatization on the one hand and the municipality's financial and economic gains on the other. If the sales price approaches the level of market price, hence the present value of the company's expected income generating capability, the public sector only scores illusory gains, as the drop in the value of its assets is equal to the revenue resulting from the transaction. In contrast, the municipality actually pockets income if the sales transaction is expected to improve efficiency and the sales price is in the proximity of the present value of profits generated by the improved efficiency