

# Can the Principles of Franchising be used to Improve Water Supply and Sanitation Services? – A Preliminary Analysis

**Meike van Ginneken, Ross Tyler and David Tagg**



THE WORLD BANK  
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Water Supply  
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**Meike van Ginneken, Ross Tyler and David Tagg**

**The World Bank, Washington, DC**



## FOREWORD

In all of our borrowing countries effective delivery of water supply and sanitation services is essential for poverty reduction. In the past years billions have been given access to water supply and sanitation. However, a daunting challenge remains to improve water supply and sanitation services to the billions who are still unserved. Investment must double from the current \$15 billion to \$30 billion annual to achieve the Millennium Development Goals. In addition, the sector – in many countries – lacks sound policies and effective institutions.

The need for sector reform and capacity building to meet this challenge is now widely accepted. Moving from principles to practice remains difficult since reforms must be customized to the social, political, and cultural circumstances of each country.

Innovation is needed to mobilize the expertise and know-how that currently is not shared widely. Franchising is one extra business model in a panorama of management models for service provision. The application of this new business model is of special interest to towns, where many of the poor live. These smaller cities are at a disadvantage when it comes to acquiring and retaining professional expertise: their systems do require comparatively sophisticated management, yet are too small to generate the resources necessary to retain professional expertise in-house.

Franchising is a method of distribution of a product or service, whereby the developer of a business concept – the franchisor – licenses an individual or enterprise – the franchisee – to operate that business concept, using the franchisor's system and brand name. Franchising is used across the world in many sectors. However, the applicability of franchising to the water supply and sanitation sector cannot simply mimic franchise arrangements in other sectors. This paper analyzes the principles of franchising as a tool to transfer knowledge and best practices to local WSS operators.

This paper is meant to encourage discussion on the applicability of franchising in the water supply and sanitation sector among water professionals and decision-makers. I look forward to the outcomes of this stimulating discussion and the possible application of this business model in our sector.

Jamal Saghir  
Director, Energy and Water  
Chairman, Water Supply and Sanitation Sector Board  
January 2004

## TABLE OF CONTENTS

1 INTRODUCTION.....	1
2 THE WATER SUPPLY AND SANITATION SECTOR.....	1
2.1 Characteristics of the Water Supply and Sanitation market .....	1
2.2 Institutional set-ups in the Water Supply and Sanitation sector .....	3
2.3 Specialized Support Mechanisms for Water Operators .....	3
3 FRANCHISING .....	5
4 APPLYING FRANCHISING IN THE WATER SUPPLY AND SANITATION SECTOR.....	6
4.1 Packages.....	6
4.2 Actors .....	8
4.2.1 Potential franchisors.....	8
4.2.2 Potential franchisees .....	9
4.3 Markets .....	9
4.3.1 Markets and packages.....	9
4.3.2 Markets and actors: Entering new market segments and market penetration .....	10
5 ARRANGEMENTS FOR FRANCHISING IN THE WATER SUPPLY AND SANITATION SECTOR .....	10
5.1 Models .....	10
5.1.1 Local franchise.....	10
5.1.2 International franchise.....	11
5.1.3 Two tiered franchise.....	11
5.2 Contract design.....	11
5.3 Fees .....	12
5.4 The Long-Term Link.....	12
5.5 Relation to other actors.....	13
5.5.1 The asset holder.....	13
5.5.2 The regulator .....	13
5.5.3 The policy maker.....	13
6 CONCLUSIONS AND NEXT STEPS .....	13
6.1 Conclusions .....	13
6.2 Next Steps.....	15



## 1 INTRODUCTION

Improving water supply and sanitation (WSS) services is a key mechanism for reducing poverty. WSS services contribute directly or indirectly to income generation, health, and education. Water is an intrinsic element of the Millennium Development Goals agreed upon by the international community in 2000. “Halving by 2015, the proportion of people without sustainable access to safe drinking water and basic sanitation” is one of the time bound targets that are embodied in the Millennium Development Goals. Reaching this target requires that roughly one quarter of a million people per day gain access to safe water and one third of a million per day gain access to adequate sanitation.

Currently, in developing countries, the overall effectiveness of WSS service provision is disappointing due to such factors as: poor management, inadequate investment, and political interference. Substantially increasing the number of people with sustainable access to WSS requires a transformation of long-established sector approaches as well as a substantial increase in WSS investments in the developing world. Foremost among reform measures are the introduction of sound policies and effective institutions at all levels. Strengthened institutions will be better able to generate cash flows, close revenue gaps, and attract financial resources. New avenues for public-public and public-private partnerships are needed. Building technical, managerial and operational capacity is, therefore, an important component of efforts to improve and expand service delivery in the WSS sector.

The decentralization of governmental responsibilities and budgets has made governments more closely accountable to their communities, while simultaneously presenting a major challenge for capacity building at the local level. Capacity building of local institutions – both governments and service providers – is crucial so that they can carry out their mandates efficiently and effectively.

Secondary cities and towns with piped distribution and collection networks are at a particular disadvantage when it comes to acquiring and retaining professional expertise. Their systems are large enough to require more sophisticated management systems, yet are too small to provide the resources necessary to retain professional expertise in-house.

The Report of the World Panel on Financing Water Infrastructure<sup>1</sup> emphasizes the twin challenges of governance and investment. The Report recommends that WSS partnerships focus on jointly working to solve problems and on “learning while doing”. Franchising in the WSS sector may provide an innovative new way to implement this recommendation.

This report examines whether or not the principles of franchising could provide decision-makers with an additional tool to transfer knowledge and best practices to WSS operators. It is a conceptual piece that investigates the issues surrounding the application of franchising in the WSS sector and is intended to stimulate further discussion of the topic among water professionals and decision-makers.

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<sup>1</sup> World Panel on Financing Water Infrastructure, Financing Water for All, World Water Council / Global Water Partnership, 2003

## 2 THE WATER SUPPLY & SANITATION SECTOR

### 2.1 Characteristics of the WSS market

WSS service provision is a complex multidisciplinary field. For the purposes of this paper, several key characteristics of the sector are highlighted, including WSS as: a service industry, a monopoly, a non-homogeneous market, a specialized professional field, and a sector lacking a critical mass of professional operators. These characteristics are discussed briefly in the paragraphs that follow.

**A service industry** — The WSS industry is a service industry where the public receives tangible and significant benefits from efficient and effective service delivery, which they pay for through tariffs and taxes. WSS service provision does not end with the construction of infrastructure. Service delivery involves providing for the operation and maintenance of assets, financial management, and for customer service on an on-going basis.

**A monopoly** — WSS exists as a natural monopoly market because of the non-substitutability of water as a product and the expensive nature of water infrastructure. Compared to competitive

markets, monopolies tend to be less productive and efficient; have lower output and service standards; and invest fewer resources in capacity building. A regulatory body can increase the effectiveness of public and private utilities by ensuring the quality of service provided and by regulating prices.

**A non-homogeneous market** — The WSS market is not a homogeneous one. One important element is population size. Within a country, the market can be segmented into population bands ranging from (mega)-cities down to towns and small rural villages (Figure 1). Each population size segment requires specific management and financing mechanisms. Particularly in the developing world, future urban growth is predicted to be disproportionately high in secondary cities<sup>2</sup>.

A second important element of the WSS market is market risk. Market risk in relation to WSS is a subjective measure encapsulating such factors as: per capita gross domestic product, political and economic stability, and exchange rate stability. Country or municipality credit ratings can be used as good proxy indicators of market risk.

Only when “population size” and “market risk” are viewed together can the enormity of the WSS challenge be clearly seen (Figure 2). Each step away from the “very low risk” segment increases the challenges for investors, while each step down the “size” scale limits the revenue base of an operator.

Figure 1: A country water and sanitation market

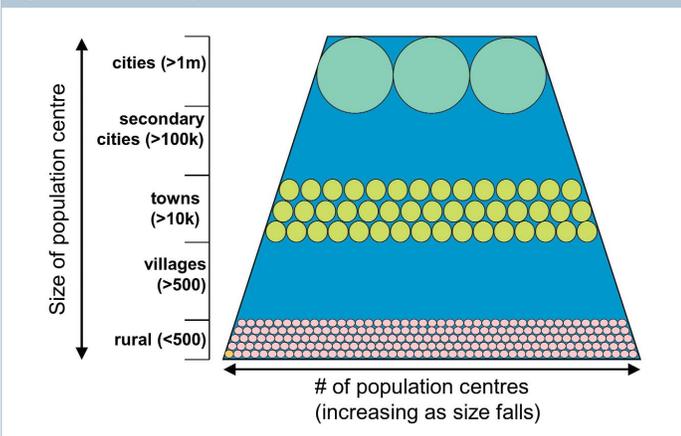
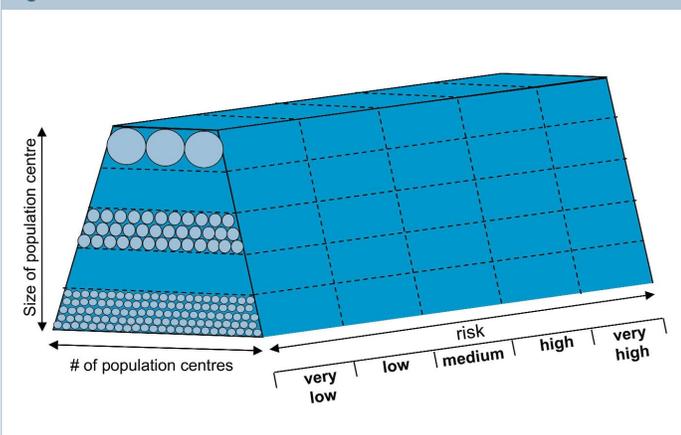


Figure 2: The world water and sanitation market



<sup>2</sup> The National Research Council Panel on Urban Population Dynamics predicts that half a billion additional people will live in cities of less than 1 million inhabitants in developing countries by 2025; this means that 60% of the urban population in developing countries will live in secondary cities by that time.

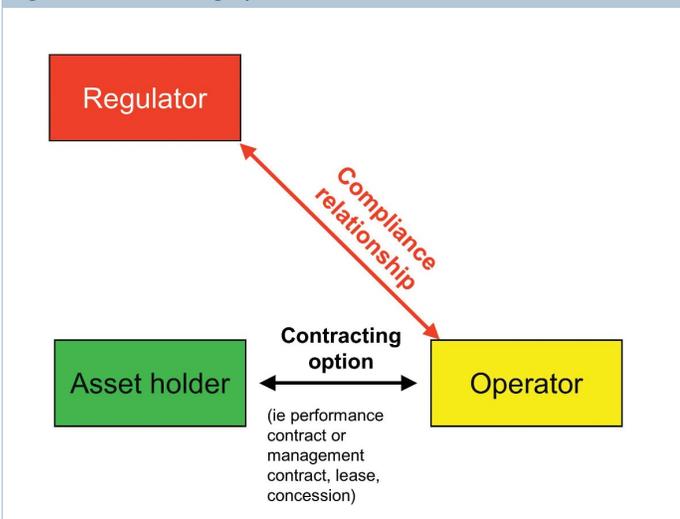
**A multidisciplinary professional field** — The WSS sector is a specialized one, and the provision of WSS services requires a competent operator. Utility staff, particularly at the managerial level, require a fairly high level of professional expertise in such areas as: asset management, billing and collection, engineering (construction, operation and maintenance), human resources management and procurement.

**Lack of professional operators** — Development of the WSS sector is hindered by the relatively small number of experienced providers, particularly at the international level. Only a few experienced private operators are active in the international WSS market. Public operators have traditionally been restricted from entering into foreign water supply and sanitation markets due to legal, political and financial constraints. In general the most accomplished operators have their roots in the “very low risk” segment of the market. Global expansion by the international operators in this segment has to date been limited to the adjacent “low risk” segment and into large cities, typically with a population of more than 500.000. The challenge is to unlock the expertise and know-how that currently resides in a relatively small portion of the WSS market, and use it to improve WSS operations in other market segments.

## 2.2 Institutional set-ups in the WSS sector

The traditional model for unreformed public service providers is a model in which all functions (ownership, regulation, oversight, and service provision) are bundled in one institution. Reform in the WSS sector is aimed at increasing autonomy and accountability through the separation of functions.

Figure 3: Contracting options



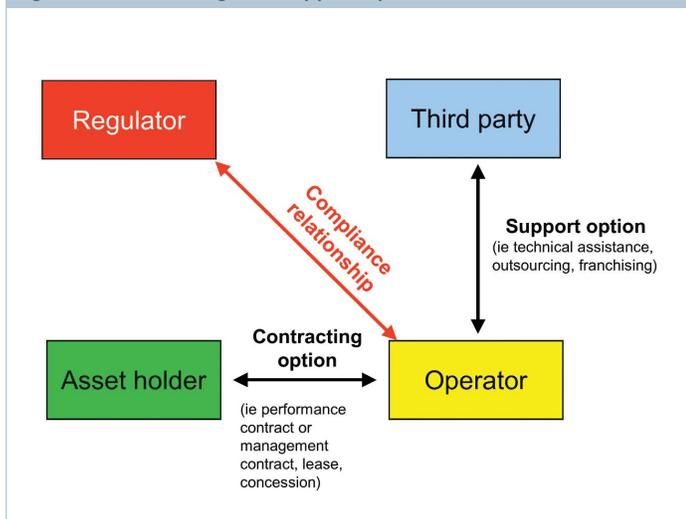
Models for reformed WSS service providers emphasize the relationship between the asset holder and the operator. Sometimes (as illustrated in Figure 3) an independent regulator is a third partner. The asset (infrastructure) holder is a local or central government institution. It both assigns the responsibility for operating the assets, and establishes a contract to manage operations, with either a publicly-owned utility (typically consisting of a “board” - providing oversight - and the management and the staff of the utility) or a private sector operator (through contracting models such as leases and concessions).

This report looks at franchising as an alternative means of supporting reformed service providers – both public and private.

## 2.3 Specialized support mechanisms for water operators

Traditionally the WSS sector has been analyzed from an urban (utility) or from a rural community managed perspective. Increasingly these two approaches can be seen as the endpoints of a continuum from rural to urban centers, where each point along the continuum requires different types of expertise and support. One-size-fits-all solutions are inappropriate given the complex environmental, socio-economic and political environments in which WSS utilities operate. There is a need for flexible support that is tailored to the individual characteristics of a utility.

Figure 4: Contracting and support options



Public utilities and private operators can secure (technical, managerial and financial support) capacity enhancement from a variety of independent third parties (see Figure 4). Such specialized support mechanisms include twinning, technical assistance, and joint venture partnerships.

**Twinning** relationships between public utilities have traditionally had limited success, due to the lack of incentives to participate in them, and the absence of real commitment and accountability from both parties.

**Technical assistance** has often been limited to consultants providing support on an ad hoc basis. Consultants typically do not share the risks inherent in the implementation of their recommendations. Thus, the overall success of utilizing this form of external support ultimately remains dependent on the skill of the utility's staff and the vision

of its management. The use of non-profit organizations to provide technical assistance (see Box 1) depends on the provision of stable and long-term financial support for these organizations.

**Joint ventures** provide high levels of commitment and involvement at the managerial level, as well as in the sharing of risks. However, the high level of financial commitment that they require has limited both their number and rate of development.

An alternative form of providing support to utilities could come from a franchise relationship, in which the supporting entity provides comprehensive and long-term support without taking an equity position in the company it is supporting. Unlike consultant contracts or twinning arrangements, under a franchising agreement, the supporter shares the risks inherent in its recommendations and its financial returns are ultimately pegged to the performance of the operator it is working with.

**BOX 1. On-Going Professional Support for Water Supply in Small Towns in the USA**

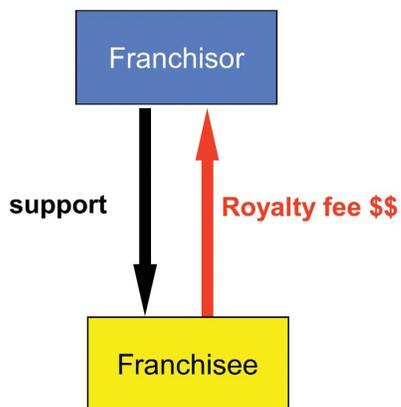
In response to problems with access to safe drinking water in the 1970's, the United States Congress appropriated funds for technical assistance services to assist rural communities with infrastructure development. Congress also allowed for the allocation of funds so that intermediary non-governmental organizations could provide technical assistance to assist local governments and rural communities (population less than 10,000) with water infrastructure development and management.

The support provided includes: public education; decision-making and utility planning; application for available loans and grants; consideration of technology options; and, regulatory compliance. In addition, the NGOs assist with the development of water asset management and financial accounting systems, and the expansion and upgrading of infrastructure systems. The communities pay for these services on an as-needed basis. That such an arrangements continues to exist thirty years later is indicative of small communities' long-term need for technical assistance in providing water services.

### 3 FRANCHISING

'Franchising' is a business methodology that focuses on the transfer of business know-how and practices, often accompanied by specific training, in order to provide the necessary skills and expertise for a particular business. The seller of the business concept and know-how is the franchisor, while the purchaser of the license agreement to use the business know-how is the franchisee (Figure 5). The franchisee pays the franchisor for the business know-how that is provided and for the use of the franchisor's business name (trademark) over a contractually defined period of time, and within a specific geographic territory.

Figure 5: Franchising – basic arrangements



The payment of the franchisee to the franchisor is in the form of a fee, often consisting of an initial upfront fee and an ongoing royalty fee - a percentage of the franchisee's gross sales.

For independent franchisees, franchising is a way of being in business 'for oneself but not by oneself'.

It is the franchisor who provides the proven business 'know-how' for the franchisee to follow. The franchisee gains by having to devote less time and resources in developing its core business functions. This allows it to focus on the needs of the immediate local market, thereby expediting its revenue stream and reducing its chances of failure.

A franchisor will usually grant the rights of its business know-how to multiple franchisees in order to diversify its risks and realize economies of scale. Franchising arrangements require capital intensive front loading on the part of the franchisor.

Consequently, franchisors spread out the start-up costs of knowledge transfer across multiple franchisees in order to realize financial benefits.

In addition to supporting the individual franchisees, the franchisor performs central functions on behalf of all of its franchisees. These functions may include new product development, advertising, and procurement functions.

The franchise relationship is fundamentally one of making experience and knowledge available for the long-term benefit of the franchisee in order to increase sales. Because the cumulative benefits obtained by the franchisee from the transfer of experience and know-how evolve incrementally over time, the franchisee continues to pay the franchisor in the form of a royalty fee. Within a franchise arrangement, there is a high interdependency between the franchisor and franchisee. The franchisor's financial success is directly linked to the financial success of each franchise. A franchisor does not finance or guarantee financing for the operations of a franchisee.

Franchising may be found at all levels of the distribution chain. For example, franchise agreements can be found between:

- manufacturers and retailers (i.e. in the early agreements between the automotive and gasoline industries in the United States)
- manufacturers and wholesalers (i.e. in the soft drink industry),

- wholesalers and retailers (i.e. in drug stores and hardware stores) and,
- retailers and retailers - the 'duplication' of successful retail operations (i.e. in the fast-food sector).

### **BOX 2. Franchising in the Hotel Industry**

Franchising in the hotel service industry is comparable to the WSS sector as it is not uncommon for the hotel building to be owned by a consortium of investors [the asset holder] who may then elect to lease the building to another company that specializes in the hotel business [the operator].

The operator of a hotel may in turn elect to become a franchisee of a large national or international hotel chain. The franchisee is then provided with training in how to organize and run the hotel in accordance with the franchisor's operations and procedures. Through this training and support, the hotel takes on a certain identity (that of the franchisor's operations). In addition, the franchisor may offer the franchisee access to 'extra services' such as, for example, advertising or a central reservation service.

The most common franchise networks involve private sector operated retail outlets. Franchising in public service industries has been hindered by the higher degrees of know-how transfer required resulting in fairly high upfront costs for franchisors. This is often combined with low revenue streams of franchisees. One well-developed service industry where franchising is a common model is the hotel industry (see Box 2). Several national postal services, including the Netherlands, the United Kingdom, Canada and Brazil, have used franchising in the reform process of part or all of the mail service (see Box 3).

### **BOX 3. Retail Post-Office Franchising in Canada**

In Canada, the national postal service continues to implement core functions, such as the collection, processing and delivery of mail, while other functions – such as the selling of postage, money orders, envelopes, and the picking up of parcels – have been delegated to franchisees of this corporation.

The franchisor, Canada Post Corporation, assists its franchisees with the development and maintenance of a customized commercial based wholesaler to retailer process. Support includes market studies, network rationalization, location analysis, retail business management, and marketing.

Franchising has allowed for fast retail network expansion at a reasonable cost. Franchisees benefit from earning revenue from the sale of postal products and services and from increased traffic through their host business. Customers benefit from improved customer service (more convenient locations and hours of service), lowered costs, and increased market coverage.

*\* For more information see [http://www.canadapost.ca/corporate/about/cpil/retail\\_franchise-e.asp](http://www.canadapost.ca/corporate/about/cpil/retail_franchise-e.asp)*

## 4 APPLYING FRANCHISING IN THE WATER SUPPLY AND SANITATION SECTOR

This paper investigates the applicability of the franchising model to the WSS sector. A water operator acting as a franchisor would provide its technical know-how regarding the operation of a water utility to other water operators (franchisees).

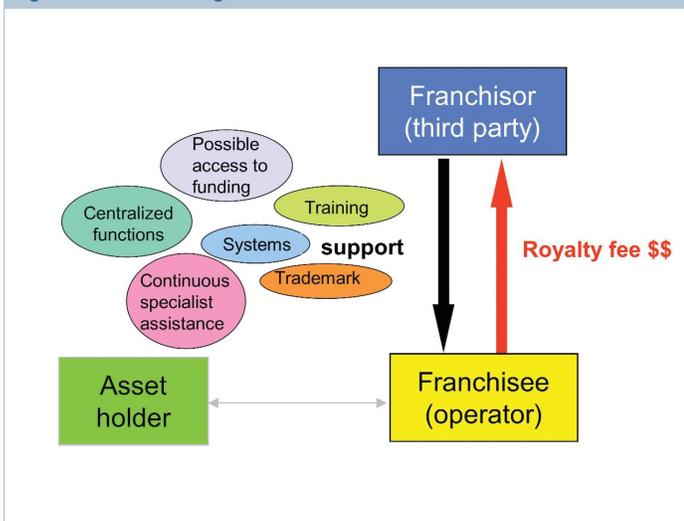
This chapter discusses franchising in terms of the support packages that could potentially be made available to WSS franchisees, the actors involved in franchising, and the characteristics of the WSS market.

### 4.1 Packages

Franchise packages must be tailored to suit the particular circumstances of operators and the market in which they operate. The franchisor and franchisee agree upon the items of the 'menu' of options that are to be included in the initial franchise package, and on the development of the package over time. They may also agree on a number of 'optional extras' that the franchisor can be called upon to provide for an extra fee.

Franchisors can provide franchisees with support in all areas of professional expertise needed to run a utility, including: asset management, billing and collection, engineering (construction, operation and maintenance), human resources management and procurement.

Figure 6: Franchising in the WSS sector



The franchisor will provide the franchisee with a range of services designed to help it meet or exceed the success of the franchisor (Figure 6). Types of services that can be provided include:

**Trademark** — The franchisor rents the use of its trademark to the franchisee for the duration of the franchise contract. The trademark might be used to provide a "track record" for bidding for a contract (see Box 4).

**Training** — In the beginning of the franchise, training will be a major part of the support provided by the franchisor in order to get the franchisee up to speed. Over time the amount of training will diminish.

**Systems** — The franchisor can rent the use of certain systems to the franchisee. Examples include accounting systems, customers' databases, and asset management systems.

**Continuous specialist assistance** — For smaller operators it is often not financially viable to maintain specialist capacity in house. Franchising offers a mechanism by which small and medium sized operations gain access to supplemental specialist capacity when needed. Examples may include planning of rehabilitation and future expansion, year-closing of accounts, production of annual report, recruitment and maintenance of high-tech equipment. While some recurring specialist assistance might be covered by the standard franchising fees, the franchise arrangement can also include a provision for 'optional extras' through an extra fee for infrequent services.

#### **BOX 4. Case Study – Argentina**

In 1995, a private Argentinean water company asked Northumbrian Water (a private British water company), for its support in a bid for private sector participation in Formosa – a project in which Northumbrian Water (NW) did not want to be directly involved.

The terms of reference for the project allowed for the pre-qualification of companies that could show the support of a suitably qualified operator. An agreement between NW and its Argentinean partner was reached in which NW provided technical assistance both during and after the bidding process, and allowed its 'track record' to be used to meet the pre-qualification requirements of the bid, in exchange for an annual royalty payment based upon a percentage of the future revenues generated and collected by the partner.

**Centralized functions** — Centralization of certain functions to be carried out by the franchisor take advantage of economies of scale. An example could be a centralized procurement system for certain goods. Through volume discounts, the franchisor can provide franchisees with better prices for materials, equipment, and services.

**Introduction to possible sources of financing** — While a franchisor does not finance – or guarantee financing for - the operations of a franchisee, it may be possible for the franchisor to introduce existing and new franchisees to lending institutions. In other sectors, franchisors play a role in brokering financing for their franchisee because of their good financial standing with commercial banks, and the trust built up by the franchisor's demonstrated ability to select successful franchisees. In addition, franchisees may have a relative advantage in attracting investments because they can demonstrate that they have access to an on-going source of expertise and training support.

#### **4.2 Actors**

Potential franchisors and franchisees require an entrepreneurial spirit that is focused on actively developing new business opportunities. Both parties have to recognize that the franchise relationship is different from a company with owned branches. A franchise does not operate according to a traditional command and control hierarchical structure, but rather demonstrates a more equal partnership in which each party can hold the other accountable to its contractual obligations. Trust is at the heart of a franchise arrangement.

##### **4.2.1 Potential franchisors**

Potential franchisor candidates must have experience in the water supply and sanitation sector and preferably have a track record in running their own operations. Potential franchisor candidates include local and international operators, which can be public, private, or non-profit entities. These groups are discussed in more detail in the paragraphs below.

**International public operators** have traditionally been restricted by legal, political, and financial constraints to operate overseas. A limited number of successful public operators have extended their operations abroad. Franchising might offer a vehicle for other public operators to enter new markets without the need for capital investment. Operators that might be legally or politically restricted from bidding for a contract, might be able to enter new markets as franchisors.

**International private operators** have been active in the large population centers within the low/medium risk market segment. For this group, franchising may be a new business strategy for in-country penetration in markets where the operator is already present, or for market entry in new higher risk markets.

**Local public operators** run the operations of a utility in a certain area. Through franchising the operator could expand its geographic area and provide specialist services to other (smaller) operators. The scenario of a local public operator becoming a franchisor seems most likely during sector reform, for instance during the decentralization of a national utility.

**Local private operators** with the relevant track record and capacity may look to franchising agreements to facilitate in-country market penetration. This category also includes local companies (such as contractors) that have gained operational experience, particularly in smaller population centers.

**Non-profit organizations** have a history of providing technical assistance to small operators, municipalities and communities. Franchising can be an option to consolidate and formalize such arrangements.

**Consortia** of public and/or private institutions might enter into the WSS service market through franchising. The advantage of forming a consortium is that the consortium takes the reputational risk, rather than the individual organization. A consortium could consist of a combination of operators, consulting firms, and contractors.

#### 4.2.2 Potential franchisees

Potential franchisee candidates include local public and private companies as well as local community groups that already operate WSS systems. In addition, new organizations may enter the WSS market through a franchising framework, such as contractors, small scale providers who want to scale up, and non-profit organizations.

**Local public operators** are a large potential group of candidates for franchising, particularly in towns in moderate to medium risk markets. This group consists of existing operators that turn to franchising in order to improve their operations and gain access to on-going support.

**Local private operators** could function as franchisees for various population sizes in all WSS markets. This group consists of existing operators who want to increase their skills and explore new market segments.

**Local private companies** from other sectors that want to enter in the WSS market can do so through franchising arrangements. Such companies may possess the necessary entrepreneurial spirit, but not the specific technical skills necessary to run an efficient and effective WSS utility. Examples of new domestic players include operators of other utilities (power, gas, etc.), consultants, and construction companies.

**Local community groups** – such as water associations - are franchisee candidates in smaller towns or villages where they are built on existing entrepreneurial local water management structures. This group may benefit in particular from standard systems, educational and procurement practices.

### 4.3 Markets

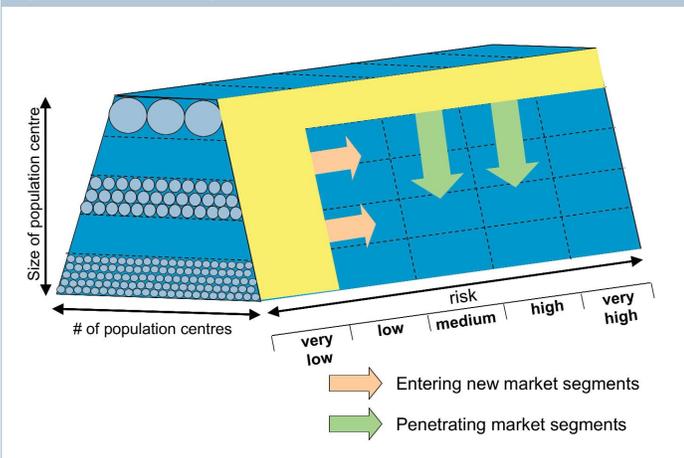
#### 4.3.1 Markets and packages

In the WSS sector, different franchising packages need to be developed that consider both the size of the population to be served and the riskiness of the market in which the franchise is to operate. Thus, franchise packages can be created on a tiered system that responds to the needs of individual franchisees and is flexible enough to change over time.

The size of a population center defines its revenue base, and thus the level of professional support service that is affordable to the operator. Small towns with little revenue must rely on small-scale, local operators and would only be able to afford simple franchising packages. Medium to large sized cities, or aggregated entities, have a larger revenue base and could purchase more sophisticated packages.

Villages and small towns require only basic support in areas such as asset management and engineering in order to run effectively. Medium sized population centers have more complicated distribution systems, and operators thus require more comprehensive operational capacity in such areas as billing and collection, human resources management and procurement. Medium sized operators require professional support for non-routine operations. Large utilities are often viable entities in their own right, with many of the specialized skills in house that are needed to effectively operate and sustain the water system.

Figure 7: Market segments & market penetration



#### 4.3.2 Markets and actors: Entering new market segments and market penetration

Each franchisor and franchisee has its own niche in terms of population size and market segment (Figure 7).

Franchising offers a business model for international operators to enter higher risk markets. As franchising does not involve capital investments, international operators might use this business model to enter into more risky markets than they would consider through traditional contracting options. However, the franchisor could face other risks such as intellectual property issues, difficulties in monitoring quality standards, difficulties in servicing the franchisees, rise in local competition, and inadequate local legal and regulatory framework.

Franchising also is a mechanism for in-country penetration to smaller population centers in markets where the operator is already present. The franchisor can be a local public or private operator, or an international operator who is present in the country through a contract in a large city.

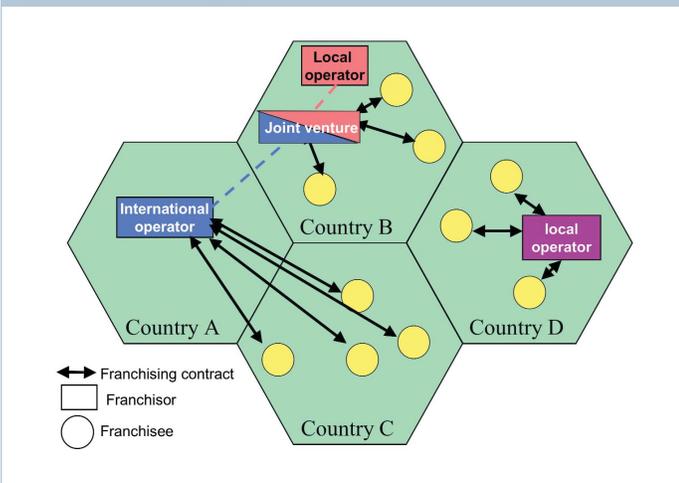
## 5 ARRANGEMENTS FOR FRANCHISING IN THE WSS SECTOR

### 5.1 Models

The different characteristics of potential franchisee groups make them attractive to different potential franchisors. There are a number of combinations and permutations by which the abovementioned potential franchisor and franchisee candidates could become involved in a franchise arrangement.

The next paragraphs map combinations of various actors in the world water market. For the purposes of this paper, three examples are discussed (see Figures 8 and 9), namely, the: local franchise, international franchise, and two tiered franchise.

Figure 8: Franchising options



#### 5.1.1 Local franchise

In this model, a local WSS operator becomes the franchisor of other WSS operators in its own country. In Figure 8, this model is illustrated in the hexagon representing Country D. The local franchisor combines low costs with local expertise. This model has a high potential for smaller population centers, where the franchising package can be simple. It may be particularly appropriate in countries that are pursuing a strategy of decentralization in the WSS sector. This model is only applicable in countries with professional and experienced service providers that are willing and able to become franchisors. This would typically be in the very low to medium risk market segments.

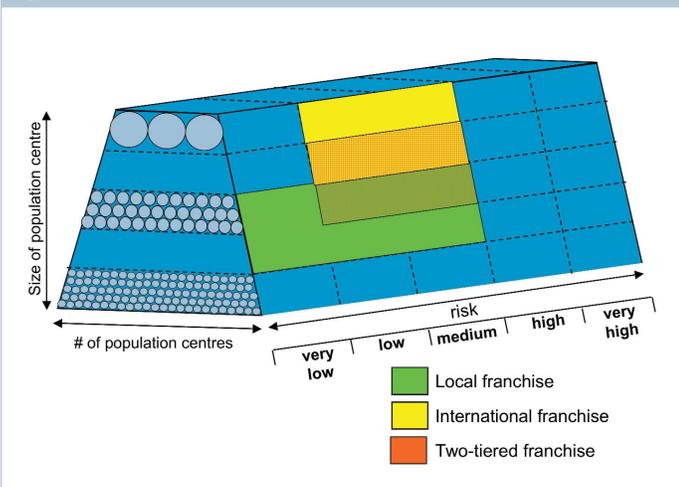
#### 5.1.2 International franchise

In Figure 8, the international franchise model is illustrated in the hexagons representing Country A and Country C. The international franchisor – domestic franchisees relationship combines a high level of expertise with relatively high costs. The start-up costs associated with this model are high, and scaling up operations to realize economies of scale is of great significance. The model would only be viable for larger population centers with large revenue basis. This arrangement has the highest potential in low and medium risk markets. This model is of particular interest for international operators who are unable to enter into the market in other ways.

#### 5.1.3 Two tiered franchise

The two tiered franchising model is also illustrated in Figure 8. In this model, an international operator has a joint venture operation in Country B. The joint venture takes on the role of franchisor vis-à-vis domestic operators. On the one hand, such a two-tiered operation can take advantage of the expertise of

Figure 9: Markets and actors



the international operator. On the other hand, the franchisor's costs are limited, as the support to the franchisees is provided from an already established in-country base. Thus, the joint venture would be more responsive to domestic issues and royalty fees for the franchisees would be lower. This model could meet the needs of secondary cities and towns in low to medium risk markets where international operators are already present through joint ventures.

## 5.2 Contract design

The design of the contract between the franchisor and the franchisee should be sufficiently comprehensive to protect the both parties from potential abuses. At the same time, however, the contract should remain flexible enough for the franchisor and franchisee to maximize potential business opportunities and accommodate changes in their working environment.

The duration of a typical franchising contract in other industries is 15 – 25 years. In the WSS sector, contract duration could be aligned with the contract between the operator and asset holder.

A franchise contract includes arrangements on the nature and scope of the franchise, the duties and rights of franchisor and franchisee, the fee structure, as well as default, termination, legal, and administrative arrangements.

## 5.3 Fees

A franchisee buys support from a franchisor for a royalty fee. The fee typically includes an:

- **initial upfront fee** – a lump sum on signing the franchise contract, and an
- **ongoing royalty fee** – a percentage of the franchisee's gross sales, calculated on a periodic basis and paid throughout the entire duration of the contract.

The franchise arrangement must provide sufficient commercial motivation for both the franchisor and franchisee over the lifetime of the agreement.

Net benefits of being a franchisee must exceed the cost of paying the franchisor over the long term. The franchisee is likely to expect either an increase in its profits, or a reduction in its costs, that is sufficient to cover the cost of the royalty to the franchisor. In the WSS sector, net benefits for the franchisee may include:

- **Market access:** Local operators entering a market might only be able to meet the bidding requirements for a contract (concession, affermage or lease) from the asset owner using the trademark and track-record of the franchisor.
- **Increased cash-flows:** In the short term, cash flow can be increased through improved billing and collection. In the longer term, it can be increased through tariff adjustments after service improvements and through expansion.
- **Reduced expenses/costs:** Cost reductions can be achieved through improving the operational efficiency of the utility and through a wide range of improvements (leakage reduction, better HR management, streamlining O&M practices, cheaper procurement of goods, etc.).

The royalty fee should cover the franchisor's costs of supporting the franchisee throughout the life of the agreement. Given the difficulty in quantifying some of the benefits and their distribution over time, much thought will need to go into the determination of the fee structure.

#### **5.4 The Long-Term link**

A healthy relationship between the franchisor and its franchisees is often achieved through the design of a franchising package that has an initial focus on "teaching and learning," and changes over time to emphasize product and service development. A franchisor takes a risk that one of its franchisees could take the transferred know-how and break the contract early, thereby saving future royalty payments to the franchisor.

There are a number of mechanisms by which to tie the franchisee to the contract over time, for example, the franchisor could insist that:

- the upfront fee cover the initial training costs of the franchisor, while ongoing fees cover long term support; and
- new contracts between franchisees and asset holder in the name of the local operator as a franchisee of the named franchisor. Thus, although the contract from the asset owner is with the local operator, the contract is contingent on the local operator upholding its franchise relationship.

The franchisor risks its reputation and corporate identity if there is a non-compliant or consistently under-performing franchisee. In a typical franchise relationship, the franchisor can exert direct control over its franchisees through its control over a key product. In the WSS sector, however, businesses are built primarily on the transfer of knowledge and skills. Thus, WSS franchise arrangements would be more dependent on the legal provisions of the franchise agreement. Guaranteeing that such provisions are upheld and enforced in emerging markets is a serious concern, particularly for international franchisors.

Default and termination arrangements have to be specified in the contract. An arbitration body should be identified or established at the outset in order to resolve disputes between parties.

#### **5.5 Relation to other actors**

In a franchise relationship in the WSS sector there are two distinct contracts. A primary contract is defined between the asset holder and the operator. A secondary contract could be used in order for the operator to obtain the formal support of another operator in the form of a franchise agreement. Policy makers and regulator are other institutions with a direct interest in the franchise relationship.

##### **5.5.1 The asset holder**

The asset holder has no contractual arrangement with the franchisor. However, both the franchisor and the asset owner are likely to develop a dialogue in order to ensure the franchisee meets its contractual commitments.

The asset holder may be reassured by the knowledge that the local operator has ready access to expertise from the franchisor, which will also be monitoring the performance of the local operator. If the asset holder finds the operator/franchisee is not performing, the franchisor can be called upon to help improve performance. This can potentially avoid the costly alternative of canceling the contract and re-tendering it.

### 5.5.2 The regulator

In some countries an independent regulator controls the WSS sector. The regulator controls whether or not the franchisee (operator) is executing its contract with the asset owner in compliance with the rules and regulations it sets out. There is no contractual or compliance relationship between the regulator and the franchisor. Both the regulator and the franchisor have an interest in maintaining a dialogue on the performance of the franchisee, however.

### 5.5.3 The policy maker

Franchising can help governments introduce a new image and 'brand' to their WSS services. Poorly run WSS services reflect poorly on governments and politicians. A franchisor's trademark, along with service improvements, can change public perception of the professionalism and quality of the service being provided. Franchising might be an alternative option for building local capacity in countries where public acceptance of traditional forms of private sector participation is limited.

## 6 CONCLUSIONS AND NEXT STEPS

This paper explores some of the issues surrounding the application of franchising to the WSS sector as a means of increasing local capacity to provide and sustain WSS services in the face of continued urban growth, particularly in medium sized cities and towns.

As water operators and utilities around the world struggle to meet the needs of the citizens they serve in a manner that is commercially viable, the principles of franchising provide a new lens through which to look for mechanisms that will engage businesses in a program of long-lasting technical support and the transfer of business acumen.

### 6.1 Conclusions

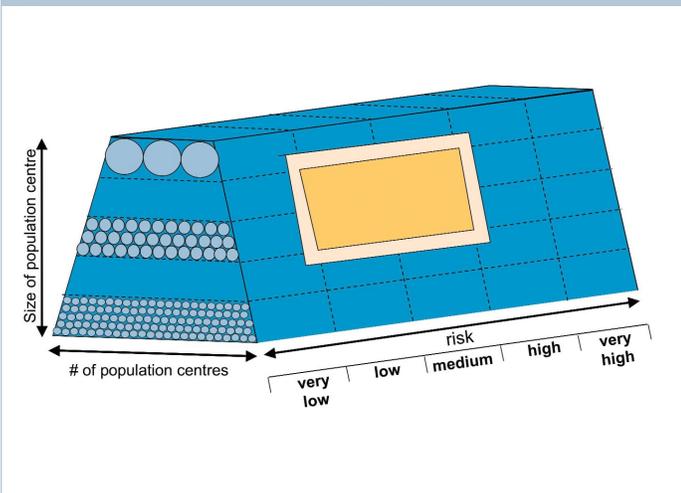
On a conceptual level, the authors have not found information that would preclude the effective application of franchising to the WSS sector.

Franchising has the potential to increase the overall effectiveness of water supply and sanitation service provision by improving the management capacity of water service providers. It takes a long-term perspective on the issue of capacity building in the WSS sector, and is flexible enough to be tailored to local needs. Strengthened service providers will – in the longer term - be better able to generate cash flows, close revenue gaps, and attract financial resources.

Franchising is one additional model among a multiplicity of models along the public-private spectrum which are being used in the WSS sector. For franchisors, franchising will only partly overcome the inherent risks of the WSS sector. As a franchisor does not invest in operations of its franchisee, it does not face foreign exchange risk. The allocation of political, regulatory and contractual risks in a franchise with a public sector franchisee are similar to the assignment of risks of a management contract with performance incentives. Political, regulatory and contractual risks for franchise with a private operator are lower. Choosing a management model for WSS service delivery will depend on local circumstances.

Franchising has considerable benefits if compared to other professional support models such as twinning and technical assistance. It creates accountability and clear risk allocation for both parties. It also provides incentives to the franchisor to improve operations.

Figure 10: Potential for franchising



The potential for franchising is highest in secondary cities and towns in low/medium risk markets (see figure 10). Franchising has the potential to provide small and medium sized urban centers with on-going access to specialized knowledge.

Franchising can build the capacity of local operators, through its focus on capacity building and the provision of business-to-business expertise. In particular, franchising can:

- enhance technical and managerial capacity of existing WSS operators in the developing world.
- increase the number of actors in the sector by empowering domestic private enterprises to enter into the sector as franchisees. Local businesses without a track record in the WSS sector can bid for contracts in partnership with a franchisor.

The principles of franchising to the WSS sectors has the potential to attract new proficient actors to the sector as franchisors and expand the operations of existing providers. Specifically, franchising can:

- provide a mechanism that reduces traditional entry barriers to new entrants in overseas markets. New entrants include successful public operators and consortia of operators, contractors, and consulting firms.
- offer a new business model with which existing international operators can expand their businesses by increasing their market penetration to smaller population centers.

Franchising is not a panacea. Uncertainties remain about the applicability of franchising to the WSS sector. In this preliminary assessment, a number of limitations have been noted.

The applicability of franchising to the water supply and sanitation sector does not mimic franchise arrangements in retail sectors, where most often a franchisor can exert direct control over its franchisees through control over a key product. Franchisors and franchisees will face inherent problems for operators in the WSS sector, such as low levels of cost recovery, ineffective regulatory frameworks, political interference. The contractual and legal provisions of a WSS franchise agreement are of fundamental importance and require careful study. The monopoly character of the WSS sector complicates these provisions. The determination of fair levels of compensation to the other party if the contract is terminated early or modified needs special attention.

The affordability of franchising for small and medium utilities in developing countries also needs further study. Even if the net benefits of being a franchisee exceed the cost of paying the franchisor, operators may not be able to afford the initial royalty fee. This limitation could be partly overcome by the use of subsidies or output based aid.

Potential franchisors might be reluctant to enter into a franchise relationship because of the risk associated with the franchisees' potential mistakes or poor performance. This performance could impact negatively on the franchisor's reputation and the other franchisees using the same name.

In addition, developing a franchisor business has a high upfront cost. Only by having multiple franchisees can a franchisor generate enough income through royalty fees to cover its expenses and spread its risks. The start-up of a viable franchisor is an expensive and long term process, involving significant risks.

## **6.2 Next Steps**

Given the potential benefits that may be obtained through the application of franchising to the WSS sector, it is recommended that the issue be further investigated and discussed.

One of the first steps that should be taken is to gauge the level of interest of organizations identified as potential franchisors and franchisees, as well as that of policy makers and financiers. The responses of these key stakeholders will also provide new insights into the applicability of the idea.

In addition, given the complexity of the WSS market and the number of variables that need to be considered, specific pilots should be examined in detail in order to reduce some of the uncertainty around the applicability of franchising to the WSS sector. Needs assessments of potential franchisees should be undertaken and linked to potential franchise package designs. The areas in which economies of scale are most readily realized should also be identified. Financial modeling is needed to determine the affordability of franchising under different conditions. Legal issues and contractual implications of franchising need to be examined in more detail.

This paper identifies franchising as one potential route to increase capacity of WSS providers. It is hoped that the ideas contained herein will inspire further investigation and discussion.

## **LIST OF WATER SUPPLY AND SANITATION SECTOR BOARD DISCUSSION PAPER SERIES**

1. *Innovative Contracts, Sound Relationships: Urban Water Sector Reform in Senegal*. Clarissa Brocklehurst and Jan G. Janssens. January, 2004



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