

# Common Regulatory Principles and Regulation of Water and Sanitation Services

Miguel Solanes, IISD Consultant

December 2009

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## Table of Contents

Introduction.....	1
1.0 Public Utility Services: Evolution .....	3
2.0 Implementing Regulation: Contracts versus comprehensive general, regulation, franchising and concessions.....	5
3.0 Common Principles of Law, Investment Arbitration and Public Interest.....	10
4.0 Public Utilities and Common Principles of Law .....	12
4.1 Ex post regulation: The need for supervening regulation of existing contracts and activities .....	13
4.2 Efficiency .....	14
4.2.1 <i>Transfer pricing</i> .....	15
4.2.2 <i>Used and usable property (investments)</i> .....	17
4.2.3 <i>Operational expenses</i> .....	18
4.2.4 <i>Debt</i> .....	19
4.2.5 <i>Efficiency and due diligence in international arbitration</i> .....	19
4.3 Economic context .....	21
4.4 Good Faith .....	22
5.0 Conclusions .....	28
Reference List.....	29

## Introduction

It has long been recognized that competition is not fully effective for certain economic activities; these therefore have to be subjected to government regulation. Businesses subject to public regulation are known collectively as “public utilities,” which include enterprises that supply, directly or indirectly, continuous or repeated services through more or less permanent physical connections between the plant of the supplier and the premises of the consumer (Phillips, 1993, p. 5). Water supply and sanitation services are the foremost example of public utility services.

Utilities operate more efficiently as monopolies, which means that they must be regulated, since a firm’s contribution to public welfare “rather than being the result of voluntary choice must be compelled” (Kaysen & Turner, 1959, pp. 48–49). The activities of public utilities are vested with a public interest. Regulation usually focuses on the conditions of the services rendered and their price. Public utility services provided by private purveyors are considered State functions, and the purveyors are thus a substitute of the State and a public servant (*Smyth v. Ames*, 1890; *Missouri ex-rel Southwestern Bell Telephone Co. v. Missouri Pub. Ser. Comm’n*, 1923).

The tradition of regulation of public utility services can be traced back to Roman law and Medieval Law. The Church Fathers devised the theory of *justum pretium*. The guilds and professional and trade corporations of the Middle Ages had a duty to provide their services to anyone desiring them, at reasonable prices. Common carriers, common tailors, common innkeepers had a monopoly of their trade and were closely regulated “common callings.” Thus, cranes, wharves, and other facilities in public ports had to charge reasonable and moderate duties, since the activity was affected by a public interest and therefore ceased to be *ius privatum* only. This was said by Lord Chief Justice Hale in his treatise *De Portibus Maris* and has been accepted without objection as an essential element in the law of property ever since (Wyman, 1904, p. 223). Regulation included price, which had to be reasonable; quality of service, which had to be adequate; and universality—services had to be provided to all who wanted them and paid accordingly (Glaeser, 1957, p. 196).

In fact, one of the first recorded cases of conflict of interest regarding a court and its powers dealt with the penalties applied to a barber surgeon by the court of the trade, which imposed a fine and had a right to keep a percentage of that fine. In 1610, in the English case *Dr. Bonham*, Chief Justice Coke found that a court whose income depends on cases is not a judge, but a party to the case (cited in Schwartz, 1993, p. 4). Regarding the act of Parliament that authorized the procedure, Lord Coke found that even an act of Parliament could not be above common right and reason, and that common law controls acts of Parliament, and sometimes adjudged them to be utterly void (Schwartz, 1993, p. 5).

In European Continental law, “services publics” (public services) are specific activities that the administration carries out, by itself or through concessionaries. They are normally activities carried out by private companies, to which the government delegates the performance of particular services, according to a system of public law, with control of rates, investments and quality of service. Penalties are provided in case of failure to perform (Pisier Koughmer, as cited in Gordillo, 1998, pp. vi–2).

Thus, in both British-based common law and Continental Law, public services, or public utilities, are subjected to regulation. To protect public interest, regulation has a directive role and is controlled by a superior, with penalties and sanctions for non-compliance. Public service are considered such because the State and its agents have to enforce regulatory law, which cannot be overreached by private agreements between the parties concerned. Because the State plays a fundamental role in the formulation and the enforcement of regulatory law, it is typically centralized (Ogus, 1994, p. 2).

In contrast, private law is decentralized, and relies on property and the freedom to contract. In this context, third party effects, inadequate and asymmetrical information, the transaction costs of individual contracts, the ex-post enforcement of private law, monopoly, public interest concerns and efficiency and equity considerations trigger and justify regulation. Market failures prompt regulation. Social policies also justify regulation: without regulation, poorer areas may have to go without essential public services. Private providers have historically concentrated on the richer areas of possible markets (cherry picking, cream skimming) leaving the poor without service. Private financing has historically also been unable to raise the capital needed to invest in infrastructure for the poor. In water and sanitation, for example, private purveyors have been successful in places where governments had already done the bulk of investment.

When the Chilean water companies were privatized they were already efficient. Good quality information regarding infrastructure, operation and maintenance was available. A significant part of the distribution network, the sewage system, as well as major production and distribution facilities already existed. Their availability reduced uncertainty. When networks are already available, the provider can know the paying population, and expansion problems are meliorated. An additional advantage was that an experienced regulator was already in place (Valenzuela & Jouravlev, 2007).

## 1.0 Public Utility Services: Evolution

In a number of countries, the initial response to the provision of public utility services was to rely on the market, private providers and competition. Yet, skepticism about the merits of markets developed very soon. Competition was not practical when dealing with network utilities, such as water and gas. Duplication of facilities was not economically efficient (Ogus, 1994, pp. 265–266).

Private providers of water supply and sanitation services developed their own set of problems. The evolution from private to public systems was the result of the abuses of private providers. They were keen about limiting their investments and expenses, affecting the quality and quantity of the service. Systems were constructed and extended to well-to-do areas only. Their systems were more expensive than publicly-owned utilities, and they did not have—or did not want to risk—capital extending the services required by growing public demands resulting from health requirements, economic needs and general development. As a result, water and sanitation services were municipalized (Flynn & Boudouris, 2005).

Public providers also took over other public utility services (gas, electricity, telephones) from private companies. In most places, public ownership under municipal corporations was the model of choice. The notable exception was the U.S., which continued relying on private suppliers, therefore originating some of the most important regulatory principles applied to private purveyors of public utility services. But even in the U.S. water supply and sanitation became a public concern under municipal ownership.

At the same time, there was a world-wide movement towards national companies. Scale economies and financial needs led to large corporations in gas, electricity and telephones.

The exception was water, which remained a municipal service in most countries, foregoing economies of scale and scope. Exceptions such as Argentina, which created a national water system in 1913 as a means to combat water-related diseases, were rare. It is only recently that countries like England and Chile evolved from municipal to regional forms of industrial organization for water and sanitation, in order to profit from economies of scale and scope. National and regional systems do also minimize transaction costs and favour expedient implementation of water and sanitation policies. Even municipal systems may afford economies of size, but they are capitalized by a small number of private purveyors serving many municipalities under separate and independent contracts (Verges, 2009, p. 15). Purveyors organized at national and international scales profit from economies of size when the customers are municipalities. The companies are organized to encompass large global markets and realize huge economies. But for every municipality, each contract is a separate unit, and they do not profit from economies, they transfer them. This is a serious structural

restriction, since the economics of the sector clearly show that it is a natural monopoly. In some cases, costs vary from one to eight per unit served, depending on a system's size (Phillips, 1993, p. 838). Countries like Chile or England transferred services from local to regional organizations for this reason. Texas is trying to consolidate services to facilitate affording higher costs resulting from higher environmental and quality requirements.

Because of the efficiencies resulting from economies of scale, companies are usually granted legal monopolies over their service areas. As a result, countries enact regulations to protect consumers. Regulations usually determine the conditions of the services, prices and environmental impacts

## 2.0 Implementing Regulation: Contracts versus comprehensive general, regulation, franchising and concessions<sup>1</sup>

There are two main trends for regulatory instruments. A number of countries, such as the United States, England and Chile favour regulation by law. France, Spain, Germany and other continental countries favour contract regulation, which is also relevant in OECD publications. Companies also prefer contract regulation, and in some countries, such as France, they have blocked the enactment of general regulations (Vergés, 2009). The selection of law or contract as the source of regulation has important legal and practical consequences.

If regulations are based on law, the margin for negotiation with, and capture of, public authorities is reduced. Legal regulatory provisions cannot be amended, nor disregarded, by the parties. Table 1 shows some of the results of implementing legal or contract regulation, and the discussion of the shortcomings of concession and franchise contracts that follows illustrates the rationale for legal regulation.

Almost 90 per cent of water supply and sanitation privatizations in Latin America and the Caribbean during the 1990s were concessions:

The popularity of concessions is easily explained by the fact that they allowed a relatively easy handling of constitutional, legal or political constraints on privatizations. With concessions, governments could, for instance, argue that they were not selling the assets of the country and hence bypass legal or constitutional constraints and reduce the criticisms of reforms by anti-privatization segments of civil society. These concession contracts [...] became the main regulatory instrument. (Estache, Guasch & Trujillo, 2003, p. 4).

Unfortunately, there are major practical problems with this approach in the water supply and sanitation industry as well as in most other public utility sectors. Franchising is affected by a number of difficulties in some circumstances. The industries where regulatory problems are greatest are particularly prone to such problems (Kay & Vickers, 1988). As Table 1 shows, water concessions had a much higher rate of post-award renegotiations than concessions in other utility sectors. This high incidence of renegotiations may be considered evidence of opportunistic bidding.

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<sup>1</sup> This section is based on Jouravlev (2000).



**Table 1: Latin America and the Caribbean: Concession Renegotiations and Characteristics of the Regulatory Frameworks (Renegotiated concessions as a percentage of the category)**

	All infrastructure sectors	Drinking water and sanitation
<b>All concessions</b>	29	75
<b>Award criterion</b>		
• Lowest rate	60	82
• Highest payment to government	11	67
• Multiple	34	0
<b>Regulatory framework</b>		
• In law	17	56
• In decree	28	84
• In contract	40	71
<b>Regulatory entity</b>		
• In place at the time of privatization	17	41
• Not in place at the time of privatization	61	88
<b>Rate regulation</b>		
• Price cap	38	89
• Rate-of-return	13	14
• Hybrid regime	24	40
<b>Regulatory obligations</b>		
• Regulating by means (investment obligations)	51	85
• Regulating by objectives (performance indicators)	24	25

Source: Estache, Guasch & Trujillo (2003)

### Other problems affecting concessions and franchises include:

**Bidding for the concession contract may fail to be competitive.** There may be very few competitors due to a scarcity of requisite skills or resources. There is also a danger of collusion among bidders, especially if they are few in number: Bidding assumes competition. This is somehow naïve once it is realized that an auction is a process aimed at limiting firms surplus. A natural reaction of those firms is to protect themselves by collusion (Laffont, 1994). An additional limitation is the fact that an incumbent franchisee is likely to enjoy strategic advantages (for example, arising from the experience gained from the operation of the system or from reluctance on the part of the franchiser to accept the disruption associated with a change of operator) that could deter potential competitors.

Lack of competition in the awarding of concession contracts is a common problem in the water supply and sanitation industry, especially in the case of relatively large projects, where only a very small group of major companies is currently involved in the concession business—from one to five

depending on the region in question (Silva, Tynan & Yilmaz, 1998). In electricity, hundreds of western firms compete to win contracts to build power plants; in the process, they reduce the returns these contracts are likely to generate. In water, though, there are just a few firms in the international market, and competition is less intense (*The Economist*, 1998). In addition, the companies belonging to this small group often band together. In France, many contracts, particularly in small cities, are awarded to just one bidder, normally the incumbent provider, benefiting from huge information asymmetries (Verges, 2009). Information asymmetries within the French system have resulted in imbalances in the allocation of risks and benefits between municipal contractors and providers. At the same time, the principle of “free contracting” facilitates collusion between local authorities and companies (Verges, 2009). In addition, the companies offer attractive employment opportunities to high-ranking public officers, a fact that discourages adequate national regulation (Verges, 2009).

Short-term contracts may encourage greater competition, but are also likely to considerably reduce incentives for maintenance and investment, especially in long-lived industry-specific assets, which are very important in the drinking water supply and sanitation sector. The organization of auctions involves major costs and considerable time. Furthermore, short-term contracts reduce incentives for cost reduction, thus increasing the risk of mediocre performance, and imply that the sector would constantly be in a state of turmoil and that the problems of asset valuation and handover occur more often.

For these and other reasons, most water supply and sanitation concessions are typically long-term (25 to 30 years). However, the longer a contract lasts, the less effect the terms determined in the initial auction will have on the terms of the service provision over the full life of the contract. In the early part of the twentieth century, in the United States, in a limited number of cities, a degree of competition for franchises to build and operate waterworks may have occurred at the beginning, but since substantial investments in fixed facilities were required, contracts were typically of long—or even indefinite—duration and recurrent bidding was not usual (Jacobson & Tarr, 1995, p. 11).

**Problems associated with asset valuation and handover in the event of an incumbent franchisee being displaced by a rival may distort incentives to invest and the nature of competition for the concession** (Bishop & Kay, 1989). In the water supply and sanitation sector, assets generally have a longer useful life and a higher component of sunk costs than in most other industries. With a substantial portion of assets underground, it tends to be difficult and expensive to assess their value. It is important to ask, for example: whether the equipment was originally purchased on competitive terms and whether there was adequate maintenance; what method of depreciation should be used; and how appropriate were past investment decisions. This, in turn, has a bearing on incentives to invest in new assets and maintain existing ones: if the incumbent anticipates that investments carried out over the life of the contract will be undervalued

(overvalued), incentives to invest in new assets and maintain existing ones will be correspondingly low (high). In any case, since it is difficult to evaluate the state of underground assets, as the franchising contract nears the end, the franchisee normally has an incentive to stop any maintenance work or even strip the assets.

**Underbidding or post-contract opportunism** (Guasch, 2004; Guasch, Laffont & Straub, 2003; Guasch & Straub, 2006). Once the contract is awarded, any move to replace the successful bidder would be disruptive and expensive and, as a general rule, governments are understandably reluctant to terminate a contract. In view of this, participating firms would have an incentive to put in speculative bids and to try to renegotiate them at a later stage. Therefore, efforts to secure private sector participation would tend in the main to attract those entrepreneurs who have greater lobbying power or who are more inclined to take risks.

**Problems of contract specification, monitoring and enforcement** (Train, 1991). Perhaps one of the most important limitations of the franchising approach arises when it is acknowledged that in a constantly changing world, the optimal price and other contractual conditions change over the course of time. Given that costs and demand conditions change, locking the franchisee into a price or other contractual conditions that were optimal at a given point in time is likely either to force it into bankruptcy or to allow it to make windfall profits: Normally, the assumptions behind the expectations in a concession contract will be quickly proven weak. Economic context and political needs change. In the water industry, assets are hidden, and as parties face reality, they want to revisit the contracts. (Lee, 1998). Lastly, it is worth mentioning that reliance upon auctions and contract-based regulation entails serious risks, especially if the government lacks the skills and bargaining leverage to ensure that the contract fairly balances public and private interests.

These and other difficulties pose serious problems that are known to have affected the franchising of public utilities in many countries. For example, from the end of the nineteenth century through to about the 1920s, public utility regulation relied on franchising in the United States:

*While use of the well-drawn franchise had some merit, in the main the franchise, as actually used, proved a defective instrument for [...] regulation [...]. Little regard was paid to the interest of the public [...][:] franchises [...] tended to be poorly drafted [...]. And even when they were well-drawn, the company often benefited, since it was common for the utility's lawyers to draft the franchise and then present it to the city council for approval. Changes in the prescribed rates or in the service standards were made with great difficulty [...]. As expected, the companies resisted downward rate changes, and the city councils, upward adjustments [...]. Service often became poor as the termination date on the franchise drew near. The company would try to keep its investment as small as possible to avoid loss if the contract was not renewed. The agreements also failed to provide for administrative machinery to keep check on the company to see it met the terms of its franchise*

*[...]. It was often impossible [...] for franchise [...] provisions to be changed [...]. Detailed requirements were unsatisfactory under changing conditions” (Phillips, 1993, pp. 130–131, 159).*

Because of the deficiencies of contract regulation, a number of countries that have successfully conducted reforms in the water and sanitation services, or otherwise manage to efficaciously control private providers, have resorted to general regulation, whose principles cannot be left aside by contracting parties, to regulate the relationships between governments and providers, providers and customers, and controlling the conditions, quality and prices of services. Providers are granted licences to operate, and not contracts. The cases of England, Chile, and the U.S. are particularly relevant.

### 3.0 Common Principles of Law, Investment Arbitration and Public Interest

Common principles of law are important. In the context of investment agreements, litigation arbitration courts are adjudicating water utilities conflicts according to a set of very limited principles, mostly ignoring common regulatory practices. This is part of a broader problem, since international arbitration judges see their activity as a private-oriented concern, mostly disregarding the broader implications of their decisions on issues such as environment, public health, governance and general well-being. Consequently, governance-inspired regulatory principles, such as providers' efficiency and due diligence, are often blatantly ignored.

As a result, there are challenges to the legitimacy of international arbitration and calls for investment arbitration courts to resort to wider and more varied sources of law than the ones they are presently using when adjudicating investment arbitration conflicts, including general principles of law applied by national courts when dealing with similar matters. Kingsbury & Schill (2009) have described the strains and shortcomings of the present situation, and the need for change, as summarized below.

### International Arbitration: A minefield?

*Investor-State arbitration may also be a brittle field. Some States are becoming increasingly wary with respect to investment treaty arbitration and investment treaty protection. The cases related to the Argentine economic emergency, and the stance taken by several other Latin American governments; highlight obvious concerns about the suitability and indeed the legitimacy of the existing system for dealing with certain situations. But also traditional capital-exporting countries, like the United States, are becoming increasingly concerned about restrictions investment treaties and investment treaty arbitration impose on their regulatory powers. The United States' experience with NAFTA Chapter 11, for example, has had a direct influence on the attitudes of the United States in more recent free trade agreement and BIT negotiations, and led to modifications to the U.S. model BIT.*

*Criticism of the system of investor-State arbitration may grow further, as traditional capital exporting States increasingly see prospects that they will become respondents in investment treaty cases. It is conceivable that in special situations some companies may begin to structure their investments in sensitive sectors of Western economies so as to come under BITs, in the same way as they already take account of trade rules in siting factories, and of tax rules in structuring their transnational operations. Using BITs skillfully and drawing on some expansive interpretations tribunals have given of what is covered as an investment by particular BITs, it would be possible to structure many assets in Western economies through offshore companies in ways that would bring them under BIT protection and thus enable investors to challenge measures taken by traditionally capital-exporting countries. BIT protection and investor-State arbitration could thus become increasingly attractive for private economic actors as a valuable safeguard against possible policy choices by Western governments. A further consideration is the dynamic in which some traditional capital-importing States, like China, are now also major sources of outward investments, including investments in Western States, some of which could be detrimentally affected by some flux in the national politics of traditional capital-exporting countries. Actions taken by Western governments in response to the 2008–2009 financial crises, for instance, have prompted more serious consideration of investment treaty issues.*

*Furthermore, although the case law is developing in sophisticated ways, there is a painful unevenness in the quality of reasoning in some awards and decisions, and in any event individual tribunals cannot easily have regard to system-level concerns given their mandate and primary responsibilities to solving an individual dispute submitted by the disputing parties in any single case. Inconsistent and conflicting decisions have resulted from various arbitrations, a factor which is precipitated by the ad hoc nature of arbitral panels and the lack of an appellate or other supervisory body that could ensure more consistency in the jurisprudence and hence increase predictability in investment treaty arbitration. Within the severe constraints imposed by the existing architecture of the investor-State arbitration system, several doctrinal approaches for improvement have considerable currency. These include the comprehensive application of general international law methods or treaty interpretation as instantiated in the Vienna Convention or the Law of Treaties (VCLT), deeper analysis and use of the customary international law which underpins or complements central investment treaty provisions, greater reference to “general principles of law” distilled through robust methodologies, and the use of principles of systemic integration and techniques of defragmentation identified by the United Nations International Law Commission and others concerned with the “fragmentation” of international law.*

Source: Kingsbury & Schill, 2009, pp. 1–4

## 4.0 Public Utilities and Common Principles of Law

There are several principles of law applied by nations that are applicable to public utilities. Some result from the law of contracts and public policy, while others belong to the field of public regulation. Mann (2006<sup>2</sup>) has analyzed the principles of general contract law that may apply to the formation and execution of public utility contracts and licenses, including: corruption, duress in the formation of a contract, undue influence in the formulation of an agreed investment, misrepresentation and non-disclosure of material information (good faith), abuse of right, mistake, constructive knowledge and unconscionability. In addition to the general principles resulting from contract law, public utilities are subjected to regulatory principles of their own. These principles result from widespread dissatisfaction with contracting practices and its results when dealing with public utilities. See Section 2 of this paper for an analysis of contracts in the public utility sector.

Some important principles accepted in countries where public utilities services have been traditionally provided by the private sector will now be analyzed. One limitation, in trying to find common principles of law applied by nations to public utility services privately provided, is the fact that, until very recently, most public utility services were publicly provided and state owned. However, the quality, endurance, sustainability, economic and social importance and tradition of the systems that provide most of the information, the United States and England, as well as the European Union, testify to the usefulness and relevance of the principles discussed in a very relevant market, and their importance for informing decisions regarding sustainability. In addition, most of the companies providing worldwide public utility services are based in the U.S., the U.K. and the E.U.

The duties of efficiency, good faith and due diligence are part of the search for common principles of law relevant to public utilities. Peru has recently enacted national regulations addressed to all providers within the national territory. Providers have a duty of economic efficiency, transparency, due diligence and good faith. Their costs have to be competitive, and their operational expenses reasonable. They have a duty to provide information, of prudent and reasonable management and to respect the rules of art and the regulations concerning technical, administrative and financial management. The duty of good faith extends to the preparation, submission and execution of contracts. Their investments must be used and useful (SUNASS, 2008, p. 377–633).

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<sup>3</sup> This paper was prepared for Centro de Apoyo a la Gestión Sustentable del Agua y el Medio Ambiente (Center for Support of Sustainable Water and Environmental Management) as part of a project on a “Vision Andina” for sustainable water management. The project’s overall funder was the International Development Research Centre (IDRC) in Ottawa, Canada.



#### 4.1 Ex post regulation: The need for supervening regulation of existing contracts and activities

In the area of utility legislation, comparative law admits the possibility of superimposing, changing or reconsidering regulations. This has been demonstrated in several classic cases in the United States and, more recently, in rate revisions in the United Kingdom. Naturally, such decisions may not deprive companies of the possibility of earning a reasonable profit or completely eliminate private property. Supervening regulation poses a major challenge to regulatory capacity, since it needs to be justified with facts and information clearly demonstrating that it is necessary, fair and not arbitrary.

Regulation has been upheld as a mechanism not only to prevent conflict situations, but also to improve the conditions under which already existing activities are performed. Adhering to Anglo-Saxon common law, the United States courts have judged that this type of business is not governed by private law (*juris privati*). It does not matter whether the activities began before regulation was adopted. If the intervening parties did not wish to submit to the regulations, they should not have interested the public in their companies (Lord Hale, as cited in Popowsky, 1996, p. 2; *Munn v. Illinois*, 1877).

Because these activities are of public interest and hold such great importance, maintaining them actually became a burden for the citizens. This is why regulation, even if ex post, is justified within certain constitutional limitations. The power to regulate is not the power to destroy (*U.S. Railroad Commission Cases*, 1886; Popowski, 1996, p. 7; *Permian Basin Area Rate Cases*, 1968; *Munn v. Illinois*, 1877). A utility company cannot be forced to work at a loss, which would be a form of confiscation. A rate can be held at the lowest possible level, but must stop short of becoming confiscatory (*Natural Gas Pipeline, United States Supreme Court*, 1942). In one of the classic cases of United States jurisprudence, the presiding judge explained that:

if the franchise is taken to mean that the most profitable return that could be got, free from competition, is protected by the constitutional guarantees of property ownership, then the power to regulate is null. On the other hand if the power to regulate withdraws the protection of the constitutional guarantees, then the property is naught. This is not a matter of economic theory, but of fair interpretation of a bargain. Neither extreme can have been meant. A midway between them must be hit. (*Cedar Rapids Gas Light Co. v. Cedar Rapids*, 1912)

The standard of “equitable interpretations” was also reinforced in the United Kingdom. In this case, rates for drinking water and sanitation, as well as criteria for rate adjustments, were set in 1989 for 10-year periods, to be reviewed every five years. However, in 1991 they were adjusted downward, at



the suggestion of the regulating agency, due to unexpected profits. In 1994, an initiative was adopted to lower acceptable profit rates as well as approved levels of capital for performing the calculations (Corrales, 1998). Two companies appealed to the Monopolies and Mergers Commission, which upheld the decision of the regulator.

In South America, decisions have also been coming out on these issues. For example, Argentina's Supreme Court of Justice (1997) held that public utilities are entitled to charge rates that will allow them to recover their costs, including investments, plus a fair, reasonable profit, as it would be unacceptable to sustain that they had a right to earn objectively limitless profits. In another case, the Argentinean Supreme Court (1998) confirmed the view that the principle of reasonable profits took precedence over contractually set rates when it stated that the concessionaire had no right to a given, immutable rate, but simply to a reasonable level of profits. The State's obligation was to monitor rate changes to see that this principle was respected. The principle of reasonable profit remained in force even in the face of declining gains, so long as profits existed and there was no threat of bankruptcy.

## 4.2 Efficiency

Public utility companies are compelled to provide adequate service at reasonable rates. In this context, efficiency is probably the most important duty of a public utility. It is the principle that prevents purveyors from over-investing and overcharging in expenses, and that takes away the incentive to transfer price with affiliated and related companies. Efficiency keeps costs at appropriate levels, and serves equity by facilitating improvements in the quality of services and their expansion to the poor. Providers act on behalf of the State. An important part of the good faith execution of their contracts and licenses rests on their duty of efficiency. One of the reasons for the wide use of private providers is that they are expected to be more efficient than public providers, a virtuous quality they often drum about. They default on the expectations they create if they are inefficient.

The duties of efficiency, good faith and due diligence are an essential part of the obligations of public utility operators in a number of countries. Thus, in the European Union, law aims for efficiency and an undertaker cannot abuse its exclusivity rights (Hantke-Domas, 2005). In the United Kingdom, under the Water Act of 2003, the Water Services Regulation Authority must exercise and perform its powers and duties in the manner that it considers best calculated to promote economy and efficiency on the part of companies providing water supply and sanitation services. At the same time, the regulator must ensure that efficiency gains are transferred to users.

According to OECD (OECD, 2007, p. 24), "activities with a monopolistic element must be subjected to regulation in the public interest. National authorities will wish to take advice from

commonly accepted good practices, including as regards the duty of efficiency on behalf of the public, transfers of efficiency, transparency, constructive notice, control of transfer pricing, and regulatory accounting”<sup>3</sup> On a related matter, the Council of State of France considered the diligence of a company in dealing with adverse circumstances, when deciding the relief to be afforded to the company.<sup>4</sup>

In the United States, a number of regulatory principles—used and useful investment, prudence review, control of transfer prices and of capital structure, supervision of operating expenses, particularly those not controlled by competitive forcers—are based on the notion of efficiency. Investments and expenses violating the duty of efficiency are closely controlled and eventually disallowed.

#### **4.2.1 Transfer pricing**

Transfer pricing is the mechanism through which utility companies exploit their procurement powers to increase their profits. They either buy overpriced supplies and services from related companies, or contract financial services at rates higher than market rates. In both cases, the holding that integrates the parties in the transaction benefits from prices and charges higher than market rates.

According to Mann (2006, p. 44), the use of transfer price could be a form of abuse of rights to inflate the costs of purchased goods and services and thus distort profit and loss margins. This kind of practice is especially open to investors that have related companies that provide goods and services to sister corporations in a corporate family. Many of the large water multinational companies have such structures. The use of transfer pricing practices is well documented in the public utilities sectors.

In the United States, this problem was detected during the first half of the twentieth century, because regulated companies formed holdings with utilities in different states, thus evading the regulatory commissions’ powers to control these transactions in other states. As a result, the Public Utility Holding Company Act (1935) was passed, providing authority to the Securities and Exchange Commission to oversee those holdings and power to the Federal Power Commission to regulate transfer prices.

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<sup>3</sup> On March 20, 2007, the Organisation for Economic Cooperation and Development (OECD) Council approved the “OECD Principles for Private Sector Participation in Infrastructure” to help governments work with private sector partners to finance and bring to fruition projects in areas of vital economic importance, such as transport, water and power supply and telecommunications. Principle 21 includes the investors’ duty to participate in infrastructure projects in good faith and with a commitment to fulfill their obligations.

<sup>4</sup> CE 21 April, 1944, *Compañía Francesa de Cables Telegráficos*.

In *Houston v. Southwestern Bell Tel. Co.* (1921), the court reviewed transfer pricing between Southern Bell and AT&T, finding that prices were reasonable and market-based. In *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Missouri* (1923), the court asserted that transfer prices should be tested under the good faith of the transaction. Commissions found the good faith test impracticable; hence, they circumvented it by qualifying the value added to the regulated company that the transaction produced.

The U.S. Supreme Court found in *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Commission of Missouri* (1923) that commissions were allowed to oversee transactions that took place without arm's length negotiations. However the Court alerted that the regulator was not the financial manager of the company; hence, the commission should undertake its analysis very carefully. Several U.S. Supreme Court decisions followed, asserting the power of the regulator to scrutinize transfer pricing.

In the European context, in *Chronopost v. Ufex and Others* (Case C-94/01), the European Court of Justice dealt with State aid allegations against La Poste, a French public undertaking, for assisting its subsidiaries. As in *Altmark* (Case C-280/00), the court asserted that the dispute analysis should take into account all the factors which an undertaking acting under normal market conditions should have taken into consideration when fixing the remuneration for the services provided. The Commission argued that La Poste was not involved in State aid as the transfer pricing with its subsidiaries was at full-cost prices (total costs plus a mark-up to remunerate equity capital investment)."

Such analysis was insufficient for the court. The monopoly position enjoyed by La Poste may have allowed it to price at full cost, but still may have transferred at lower cost enjoyed by its dominant position. The court affirmed that there was State aid if the remuneration received in return is less than that which would have been demanded under normal market conditions. Finally, the court set a clear record of total cost recovery as normal market condition. On that basis, there is no question of State aid to SFMI-Chronopost if: (i) it established that the price charged properly covers all the additional, variable costs incurred in providing the logistical and commercial assistance, an appropriate contribution to the fixed costs arising from use of the postal network and an adequate return on the capital investment in so far as it is used for SFMI-Chronopost's competitive activity; and if (ii) there is nothing to suggest that those elements have been underestimated or fixed in an arbitrary fashion.

In any case, the European Community has issued two directives (Utilities Directive 93/38/EEC and the Revised Utilities Directive 2004/17/EC) to deal with transfer pricing of utilities through procurement rules. Probably the most advanced regulation in Europe is the British regulatory accounting guidelines issued by Ofwat, which controls transactions at arm's length and provides for a ring fence of the utility.

In Chile, the General Law of Sanitary Services (*Ley General de Servicios Sanitarios*) provides for a soft regulation of transfer pricing. Indeed, only one article forbids deals between holding companies when a threshold of US\$16,000 is surpassed, unless the deal is struck in a bidding process. Additionally, there is a legally obligatory bidding process for deals in excess of US\$160,000. Besides the legal regulation, the Chilean water regulator has issued several guidelines regarding transfer prices to gather information for price review purposes. Despite the law, Chilean water utilities have managed to chunk transactions into amounts lower than the thresholds to avoid the bidding process.

In 2004, the Chilean Securities and Exchange Commission (*Superintendencia de Valores y Seguros*) discovered that the Chief Executive Officer of ESSBIO, one of the largest water utilities in Chile, did not inform the company's board of directors that he was holding shares in one company (HIDROSAN) that was awarded by ESSBIO with several infrastructure contracts in different bidding processes between 2000 and 2003. According to the Chilean Securities Act, such conduct is improper, and the CEO was heavily fined (Hantke-Domas, 2005, pp. 20–21).

#### **4.2.2 Used and usable property (investments)**

As a result of the general duty of efficiency, in some cases the regulator may disallow goods and facilities from the regulatory asset base, as it considers them an inefficient investment. For example, in 1999 a Spanish and French-owned water utility in Chile (Aguas Andinas S.A.) projected a large investment on sewerage works during its price review, which was challenged by the regulator (*Superintendencia de Servicios Sanitarios*). A panel of experts solved the dispute in favour of Aguas Andinas S.A. The regulator, unconvinced by the amount allowed for the construction of the water works for Santiago—which included one of the biggest sewerage works in the world, called La Farfana—challenged it in the next price review in 2004–2005. The regulator argued on that opportunity that La Farfana was an overinvestment. Again, the issue was put before the panel of experts, where the regulator provided evidence that an optimized investment on water works for Santiago was 40 per cent less than the previously adjudicated by the panel in 1999. The utility opposed. Finally, the panel decided in favour of the regulator, as the optimization of the investment needed showed that reducing it to 60 per cent—compared with the investment allowed in 1999—was efficient (Hantke-Domas, 2005, pp. 40–42).

Efficient capital investment is a trademark of the American regulatory system. Companies can only collect revenue based on prudent investment. According to Louis Brandeis, a prestigious member of the U.S. Supreme Court in the 1920s, this is the proper measure of value. In *Missouri ex rel. Southwestern Bell Telephone Company v. Missouri Public Service Commission* (1923), his dissent stated that the investor agrees, by embarking capital into a utility, that its charges to the public shall be reasonable. His company is a substitute for the state in the performance of the public service, thus becoming a public servant. The thing devoted by the investor to the public use is the capital embarked in the

enterprise. Upon the capital invested the Federal Constitution guarantees a fair return (Phillips, 1993, p. 325). The compensation is the opportunity to earn a reasonable cost for conducting business (p. 326). The reasonable rate to be prescribed by a Commission may allow an efficiently managed utility much more. The notion of prudent investment of Brandeis, has been adopted, in part. Commissions may choose the notion of prudent investment, to set up the rate base. The Constitution does not bind rate-making to any single formula or combination of formulas (*Federal Power Comm'n v. Natural Gas Pipeline Co.* 1942). Moreover, it was found that the maze of formulas facing judges were too frequently invented for the purpose of confusing (*McCart v. Indianapolis Water Company Co.*, 302 U.S. 419,428-9 (1938), cited in Phillips, p. 326)

Investment has to be actually used and useful in providing services. If not, or if it were imprudent, it could be excluded from the rate base. The concept of prudent investment includes the economic desirability of an investment (Phillips, 1993, p. 340).

Investments are also judged according to the prudence of the investment. It has to be done with care, caution, good judgement and foresight; it has to look ahead. A review of prudence entails the determination of whether the actions of the company, according to what it knew or should have known, were reasonable and prudent in light of the circumstances that then existed. The question is to determine how reasonable people would have performed the task confronted by the company (*Consolidated Edison*, 1979, p. 363). Prudence investigations have disallowed costs related to construction (excess construction), excess capacity, untimely cancellation of a plant, halting of construction, capacity more expensive than alternative energy sources or the optimal supply alternatives, and cost overruns. Construction-related imprudent investments are generally excluded from rate base and asset-base write-offs. The others are generally shared between rate-payers and stockholders.

### 4.2.3 Operational expenses

When competitive forces are fully at play, operational expenses generally are not a problem. But there are conflicts associated with charging certain costs to operational expenses or to owners, to be paid out of earnings—management can vote itself excessive salaries and pensions or payments to affiliated companies might be excessive. Expenses for advertising, public relations, rate investigations and litigation should be closely scrutinized, to determine if they represent an abuse of discretion or are extravagant. Generally these cases request proof of reasonableness, and courts have approved the right of regulatory commissions to control expenses (Phillips, 1993, p. 256). High management salaries, and transactions with affiliated companies conducted outside competitive markets without “arm’s length bargaining,” have been controlled (*Chicago & Grand T Ry v. Wellman*, 1892; *Missouri ex rel. Southwestern Telephone Co. v. Missouri Public Services Commission*, 1923). Abuse of discretion by companies, extravagant, unnecessary, improvident, unreasonable and inefficient expenditures can be disallowed. Commissions can question the judgment and integrity of

management (*Acker v. United States*, 1936; *Smith v. Illinois Bell Co.*, 1930; *West Ohio Gas Co. v. Public Utilities Commission*, 1935; *Potomac Elec. Power Co*, 1991; *Ripon United Tel Co.*, 1923).

#### 4.2.4 Debt

Advanced regulatory systems do also control the level of indebtedness of public utility companies. The experience of U.S. regulatory commissions is that high levels of debt are not desirable (Phillips, 1993, p. 236). Public utilities may finance their investment through equity or through debt. This is known as capital structure. If debt is too high, fixed charges are high and have to be paid by consumers. Likewise, the cost of capital increases financial risks and therefore costs. Users pay these costs. That is why the debt-capital ratio is closely controlled. The maximum theoretical rate of debt in the United Kingdom, for example, is one, or 50 per cent debt and 50 per cent equity. In Buenos Aires, the ratio is 2.4.

#### 4.2.5 Efficiency and due diligence in international arbitration

Investment agreements are not insurance policies against bad business judgment (Muchlinski, 2006). Corporate social responsibility requires that investment agreements do not foster moral hazard problems by encouraging reckless or speculative adventures. This was the decision in *Waste Management v. Mexico (ICSID Case No. ARB(AF)/00/3)*, ; “It is clear that the arrangement was not commercially viable, taking into account both the lower than expected proportion of customers serviced and the additional costs incurred” (Crawford, Civiletti & Gómez, 2004, p. 20). Investors should not fail to do proper feasibility studies. Similar reasoning was applied in *MTD Equity Sdn. & MTD Chile v. Chile* (2004). In *Alex Genin and others v. Estonia (ICSID, 25th June, 2001)*, the tribunal found that the officers of the claimant had acted unprofessionally and carelessly, failing to make a proper assessment, when they should have been particularly careful, knowing that the parent company was on the verge of bankruptcy. The responsibility for the loss was the claimant’s alone (Muchlinski, 2006).

The foreign investor should also consider the investment climate of the host country. Serious economic crisis, as well as the situation of transitional economies, and the profits and returns of the claimant, are also important considerations. A few international investment cases have acknowledged that economic crisis is a valid reason to restrict tariff increases. *LG&E v. Argentina ICSID* (October 3, 2006) accepted tariffs restrictions in keeping with national decisions on rates and tariffs at times of crisis.

United States decisions are particularly relevant in this respect. During the depression years of the 1930s, the [United States Supreme] Court recognized the decline in interest rates and in business earnings throughout the country, and was willing to accept lower rates of return for public utility companies (Phillips, 1993). In the *Federal Power Commission v. Natural Gas Pipeline Co. case of 1942*, the



Court ruled that the evidence shows that profits earned by individual industrial corporations declined from 11.3 per cent on invested capital in 1929 to 5.1 per cent in 1938. The profits of utility corporations declined during the same period from 7.2 per cent to 5.1 per cent. For railroad corporations, the decline was from 6.4 per cent to 2.3 per cent. Interest rates were at a low level on all forms of investment and among the lowest that have ever existed. The securities of natural gas companies were sold at rates of return of from 3 per cent to 6 per cent with yields on most of their bond issues between 3 per cent and 4 per cent. The interest on large loans ranged from 2 per cent to 3.25 per cent. The regulated business here seems exceptionally free from hazards that might otherwise call for special consideration in determining the fair rate of return.

When foreign investors' losses can be attributed to bad management of the business or investment rather than to regulatory actions by the host country, compensatory claims should not be accepted (Muchlinski, 2006). Investments should be managed in a manner that ensures their economic viability and foreign investors must be aware of the regulatory environment.<sup>5</sup> Thus, in *Webb's Fabulous Pharmacies, Inc. v. Beckwith* (1980), the United States Supreme Court asserted that "a mere unilateral expectation or an abstract need is not a property interest entitled to protection."<sup>6</sup> The court also held that an investment-backed expectation was unreasonable if constructive notice of regulation was previously known (United States Supreme Court, *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1984 and *Nollan v. California Coastal Commission*, 483 U.S. 825 1987) The constructive notice accounts for information available to the public, even the existence of a general regulatory scheme, necessary to be considered at the time of taking a decision of buying or investing in property. In *Methanex Corporation v. United States* (2005), foreign investors were told that the political economy of environmental regulation implied a continuous process of monitoring and control (Mann, H. (2005).<sup>7</sup> Foreign investors must comply with local regulations *Emilio Agustin Maffezini v. The Kingdom of Spain* (ICSID, Case No. ARB/97/7), Award, November 13, 2000) and take relevant professional advice (*Marvin Feldman v. Mexico, International Centre for Settlement of Investment Disputes, Case No. ARB (AF)/99/1 and ADF v. United States* (ICSID Award of 9 January 2003), and also assume a corporate responsibility to act in the best interests of the host country and its economic development. Foreign investors must take reasonable care in the conduct of investments, so that, as far as possible, the interests of stakeholders can be realized, within the corporate responsibility to act in the best interests of the host country and its economic development (Muchlinski, 2006).

<sup>5</sup> In modern regulatory and public utilities law, at the national level, investors providing public utility services have an obligation of efficiency, on behalf of consumers, which has the objective to prevent overcapitalization, excessive operational costs, transfer pricing, excessive debt, etc.

<sup>6</sup> "A [...] reasonable investment-backed expectation [...] must be more than a [...] unilateral expectation or an abstract need" (United States Supreme Court, 1980).

<sup>7</sup> "Methanex entered a political economy in which it was widely known, if not notorious, that governmental environmental and health protection institutions at the federal and state level, operating under the vigilant eyes of the media, interested corporations, non-governmental organizations and a politically active electorate, continuously monitored the use and impact of chemical compounds and commonly prohibited or restricted the use of some of those compounds for environmental and/or health reasons" (Rowley, Reisman & Veeder, cited in *Methanex*, 2005).

### 4.3 Economic context

One of the most arduous and controversial problems posed by privatizations is failure as a result of economic crisis. While some decisions have accepted economic crisis as a justification for changes and restrictions on the rates of private utilities, this has not always been the case. The cases related to the Argentine economic emergency, and the stance taken by several other Latin American governments, highlight concerns about the suitability and indeed the legitimacy of the existing system for dealing with certain situations. In fact, by not acknowledging the effect that economic circumstances have on the sustainability and affordability of public utility services, investment arbitration courts are creating a huge gap between what has been done in this respect by the most representative legal systems in the world and their decisions. Economic context has been relevant both in public law and in the execution of private contracts.

As a result of the economic crisis of 1929, American courts developed a complex jurisprudence on the impact that economic crisis had on utilities, and on the consequences of such impacts. Companies have a right to collect a reasonable price for their services and regulators cannot force them to work at a loss. At the same time, a reasonable return is not guaranteed and under certain adverse economic conditions it is possible that no rate will cover the cost of the service (Phillips, 1993, p. 119). The earnings of a company cannot be summarized in a specific sum, or determined by a precise formula. They vary with the conditions of the company and the economy (Phillips, 1993, 181).

A number of cases attest to the rates-economy relationship, including: *Wilcox v. Consolidated Gas* (1909); *Lincoln Gas and Electric Light v. Lincoln* (1919); *Missouri ex-rel Southwestern Bell Telephone Co. v. Missouri Pub. Services Commission* (1923); and *McCardle v. Indianapolis Water* (1926). In addition to these cases, where there is a clear relationship between utilities and the general situation of the economy; in fact, there are others that make a direct reference to the economic depression of 1929. They noted that in the climate of the economic depression, companies making a net return of 4.98 per cent per year are fortunate, for few companies are able to do this, as rates depend on the business climate (*Alexandria Water Company v. City Council of Alexandria*, 1934). The adverse economic situation did also justify the decision in *Dayton Power and Gas* (*Dayton Power and Gas Co. v. Public Utilities Comm'n*, 1934).

English regulatory law has also resorted to general economic situations to justify decisions. As for cost pass-through provisions, the licenses allow the Director General of Water Services (DGWS) to adjust price limits between regulatory reviews in certain pre-specified cases where circumstances change significantly. The arrangements are symmetrical, either the DGWS or the utilities can use them. Key factors include: changes in legal obligations placed on utilities (e.g., new water quality and environmental standards), failure to achieve legal requirements allowed for when price limits were



set, and allowing for differences between the actual proceeds of surplus land and the proceeds assumed when price limits were last set. The procedure operates as follows: a company makes an application for cost pass-through, then the DGWS assesses the appropriate net additional costs or revenue loss, tests against the specified materiality threshold and adjusts future price limits only if the approved changes exceed the threshold; otherwise, the process is delayed until the following year (if a new application for cost pass-through is made) or until the next periodic review. Cost pass-through provisions have been used both by the water companies (e.g., to deal with the increased costs resulting from the tightening of environmental controls) and the DGWS. In the early nineties, most utilities had their price caps reduced, through both voluntary agreements and formal process, on the basis that the recession of the early 1990s had reduced construction costs below the levels assumed in 1989) (Jouravlev, 2000).

The consideration of general economic circumstances—particularly exceptionally critical economic circumstances—their effects on contracts and providing relief to those affected by the crisis, are part of the legal tradition of a number of countries. Those affected by crisis, are part of the legal tradition of a number of countries. In 1934, at the time of the Great Depression, the American Supreme Court upheld the power of the government to enact moratory laws for the relief of debtors. Judge Hughes’s opinion found that the economic emergency was a legitimate occasion for the exercise of police powers for the protection of both debtors and the community against the collapse of values that had occurred (*Home Building and Loan Association v. Blaisdell*; Schwartz, 1993, pp. 230–231).

Blaisdell, in many respects, recognizes that significant changes in circumstances merit and justify reforms to ordinary, day to day, legal principles, such as *pacta sunt servanda*. The principle *rebus sic stantibus* (changes in circumstances merit changes or adjustments to usual contract law) signifies that if circumstances change, manners of execution of contracts should adjust to the changes in environment where a contract has to be executed. Germany incorporated the principle, by way of elaborations and developments on the principle of good faith (arts 157 and 242 BGB) as a result of the economic crisis of the Post World War I convulsions. Italy and Portugal have incorporated the principle into their civil codes. France has recognized the principle through special legislation (Spota, 1977, p. 529).

#### 4.4 Good Faith

“Equitable” conduct means a balancing process that applies principles of justice to correct or to supplement the law, and where the person “who comes to equity must come with clean hands,” with a duty to do equity, to have equity. That is why unconscionable claims are set aside. The behaviour of foreign investors is of public interest to the host country, particularly when such investors develop important oil, mineral, or forestry resources, or when they provide public utility services

(Muchlinski, 2006). That is why—however unorganized—a number of decisions have stressed the duties and responsibilities of foreign investors. Fraud, misrepresentation, undue influence or abuse of power on the part of an investor may vitiate its claims. Contracts would also be vitiated by sufficient evidence of unlawful conduct on the part of the investor. The conduct of the foreign investor may be weighted against the conduct of the host country authorities in determining whether the latter had indeed acted wrongly (Muchlinski, 2006).

The foreign investor has an obligation to behave with candour and transparency in dealings with the host country authorities. For example, the investor in *Alex Genin and others v. Estonia* (2001) should have provided information to financial authorities, cooperating prudentially, something that it failed to do (Muchlinski, 2006). The country was coming to grips with the realities of modern financing and banking practices, and the foreign investor knowingly chose to invest there. The greater the inexperience of the host State, the greater the investor's duty to act with candour and transparency, in order not to abuse the inexperience of the host country. Transitional and developing economies are inexperienced. Such inexperience should not be taken advantage of. There is also the possibility that foreign investors can abuse a superior bargaining position, to extract financial benefits from it unduly (Muchlinski, 2006). In the field of public utilities, this would be the case of an investor coming into public utilities sectors with strategic biddings, intending to renegotiate later.

Good faith is an essential element of contract law. It is particularly important in public utilities regulation where the “agent-principal” problem has a particular grip. There is a considerable asymmetry of information, resources and economic power between providers and regulators. Without good faith, the relationships between the public, the regulator and the utilities are seriously imperilled. The main duty of the provider is to supply adequate service at a reasonable price. This duty is hard to fulfil if the supplier is not efficient, a main reason for countries to contract private suppliers. If an investor has reasonable profit expectations, a country has a reasonable expectation that the provider will be efficient and act in good faith. Yet, there are several incentives for the supplier not to be socially efficient: it can transfer prices, increasing its overall profits; it can vote high salaries and expensive perks to management; it can aggressively bid for contracts, with an intention to renegotiate; and it can incur high levels of debt, in order not to risk its own capital.

In many cases bad faith means corruption, with a devastating impact on water supply and sanitation:

*Corruption affects both private and public water services and hurts all countries, rich and poor. In wealthier countries, corruption risks are concentrated in the awarding of contracts for building and operating municipal water infrastructure. The stakes are high: this is a market worth an estimated US\$210 billion annually in Western Europe, North America and Japan alone. In developing countries, corruption is estimated to raise the price for connecting a household to a water network by as much as 30 per cent. This inflates the overall costs for achieving the Millennium Development*

*Goals (MDGs) for water and sanitation, cornerstones for remedying the global water crisis, by more than US\$48 billion. (Water Integrity Network, 2008, p. 59)*

The impact of corruption in the water sector on lives, livelihoods, food security and international cooperation also underscores the many linkages to global policy concerns.

When State capture occurs, the decision-making process and enforcement of water policies are manipulated to favour the interests of a few influential water users or service providers at the expense of the broader public. Public utilities are very vulnerable to political interference by corrupt policy-makers intent on awarding lucrative public sector jobs to cronies, tweaking water provision and pricing in favour of influential supporters or diverting money from public budgets into their own pockets. With private sector involvement, corruption hot spots include bid-rigging, collusion and bribery. These practices occur when private contractors vie for large water contracts and infrastructure assets are privatized in complex deals. Be it public or private, strategic collusion can game the system and exploit corruption opportunities if additional checks and balances are weak (Water Integrity Network, 2008, p. 59).

In the context of investment treaties, the question of corruption is a thorny issue. One reason is that treaties define the rights of investors, but do not elaborate either on the duties of investors or on the regulatory rights of States. Another reason is that some cases have ruled that if corruption is not argued by the host country it cannot be considered by a tribunal. There are also elements of moral hazard, and wrong design and incentives, that affect the system. Wells and Ahmed (2007) name a number of failed foreign-owned projects where local partners were powerful political figures, their relatives or associates. When these corrupted national associates remain through different government terms, some governments have instructed their lawyers not to invoke the corruption argument. Institutional weakness, economic needs and corruption facilitate a waterfall effect in which large economic groups, sometimes assisted by their governments, lobby regulatory structures limiting their independence and impartiality (Lentini, 2004).

While corruption means the absolute lack of good faith, it is also ignored in subtler manners. Rigid and exegetic interpretation of investment treaties favouring investors over countries may also violate good faith. A particular feature of most investment treaties is that they make provisions for investor rights without addressing in a comprehensive fashion the relationship of these to continuing powers of State regulation. It is likely that States' parties typically do not intend a severe occlusion of these regulatory powers, and a good faith reading of the text of the applicable treaty in context and in light of the object and purpose of the treaty may well indicate that interpretation calls for a balance to be struck between investor protection and State regulatory powers (Kingsbury & Schill, 2009, p. 23).

In the re-emergence of European private law (Zimmermann & Wittaker, 2000, p. 11), good faith plays a crucial role. It is vital for the German legal system (p. 13). It is part of the EU Directive on

Unfair Terms of Consumer Contracts, adopted by all European countries, and it is also part of the Principles of European Contract Law of the Land Commission and of the Principles of International Commercial Contracts of UNIDROIT, which emphasize good faith and fair dealing (p. 13).

In Roman law, good faith was at the core of the *exceptio doli*, and of the criteria to decide litigation related to consensual contracts. In the Middle Ages, good faith evolved into *aequitas* and was considered essential for those who trade and do commerce (Zimmermann & Wittaker, 2000, pp. 17–18). In German law, it blended with fidelity and faith, to ultimately culminate into articles 157 and 242 of the German Civil Code: “contracts are to be interpreted according to the requirements of good faith, ordinary usage being taken into consideration.” Moreover, the principle gives rise to a set of ancillary duties: cooperation, disclosure, documentation, protection and information. Good faith may have effects after a contract has been performed and in the pre-contractual phase, and prevents the abusive exercise of rights by limiting the exercise of contractual rights (p. 24). Good faith was also the basis of *rebus sic stantibus* in German Law, utilized to prevent grave injustice.

The common law was also not immune from the concept of good faith, which grew slowly with time. Thus, by the 18th century, the high watermark of good faith in common law was reached, so that in 1766 Lord Mansfield (1705–1793), who served as Chief Justice of King’s Bench from 1756 to 1788, could refer to good faith as the governing principle applicable to all contracts and dealings (Tetley, 2004). Yet, a distrust of subjective rulings very much restricted the notion of good faith in British common law. In subsequent developments, common law developed a piecemeal approach to good faith. The notion lied at the root of institutions such as common law rules on mistake and misrepresentation, duress (including economic duress) and undue influence, the objective interpretation of contracts, the concept of unconscionability, implied terms, waiver and estoppels. It is considered to be applicable in the performance of contracts (Tetley, 2004, p. 13).

Yet, even in English common law there is a duty to respect the reasonable expectations of honest people, and: “After all, there is not a world of difference between the objective requirement of good faith and the reasonable expectations of parties” (Tetley, 2004, p. 28). In addition, good faith has been accepted in a number of statutes, and also in implementing, thorough U.K. regulations and E.U. directives.

English law has also developed a strong equitable notion of fiduciary obligations, which is especially relevant in matters of agency and trust. The fiduciary relationship is rooted in a concept of loyalty of which good faith is a key ingredient. The notion is particularly relevant to public utilities, which are agencies of the government, even if private, based on trust. As stated in *Bristol and West Building Society v. Mothewe*:

*A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his constitute own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary. (1998 Cb. 1 at 18 (C.A. per Millett L.J.). Cited with approval by the Privy Council in *Arklow Investments Ltd. v. Maclean* [2000] 1 W.L.R. 594 at 599 (P.C.). Tetley, 2004, pp. 21–22)*

When confronted with the notion of fiduciary obligations, the utilities specialist cannot but think of the purveyor that butters up utility contracts through price transfers and intra-holding procurement, or the purveyor that enters a contract knowing that its initial bidding is only a strategy to eliminate competitors to renegotiate later on a one-to-one basis with the government. Because of the agent-principal asymmetry of information, and the expectations of efficiency and diligence that come with private providers of public utility services, a public utility contract is a fiduciary obligation. Good faith is of the essence, considering the many self-proclamations of efficiency done by the industry and their endorsements by international financial organizations. Countries received many constructive notices and information concerning the quality, honesty and efficiency of private providers. Countries' reasonable expectations were built around the self-asserted, and internationally-endorsed, merits of international private providers. The fiduciary obligation is overriding, considering that public utilities act on behalf of the state for the realization of a public interest.

A number of Australian cases (*Renard Constructions (ME) Pty Ltd v. Minister for Public Works* (1992) 26 NSWLR 234 and cases following that decision, such as *Vodafone Pacific Ltd v. Mobile Innovations Ltd* [2004] NSWCA 15) support the idea that “good faith” is synonymous with “reasonableness” or that there are two co-extensive duties, one of good faith and the other of reasonableness (Peden, 2009, pp. 1–2, and notes therein). It is a restriction on rights and a relief against forfeiture and unconscionability. For the English Court of Appeal, good faith is aligned with honesty and rationality, and distinguished from reasonable care or objective reasonableness (Peden, 2009, p. 2). In both England and Australia, the present approach is to imply a term requiring good faith or reasonable exercise of rights or powers.

In *Socimer International Bank Ltd v. Standard Bank Ltd* (2008) the English Court of Appeal decided that: (i) good faith is implicit in contracts; (ii) the meaning of good faith is honesty and operates to control issues of self-interest ([2008] 1 Lloyd's Rep 558, Peden, 2009). The standard of behaviour required by good faith would only be honesty, loyalty to the contract and a requirement to consider

the interests of the other party. This would place contractual exercise of discretions in the same position as the general exercise of powers: they must be exercised for a “proper purpose” within the context of the contract (Peden, 2009, p. 16).

In the United States today, the concept of good faith is rather found in statute, for example section 1-203 of the Uniform Commercial Code (UCC), which states, “[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.” In the same way, the 2nd Restatement of Contracts (1981) at section 205 stipulates that, “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.” Good faith is defined in comment (a) to section 205, as “faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.” Section 205 goes on to state that good faith and fair dealing in the performance of a contract requires more than mere honesty (Tetley, 2004, p. 130).

Civil law regimes take an expansive approach to the obligation of good faith, applying it to both the formation of a contract and its performance statute. The civil law principle of good faith is based on the concept that contracts are a relationship between two parties; therefore the obligation of good faith exists during negotiations and even before a contractual relationship may exist (Tetley, 2004, pp. 8–9). The French Civil Code (1804), includes the principle of good faith in particular situations, for example contracts at 1134 c.c. and prescription, at articles 2265, 2268, 2269.

The new Civil Code of Québec (CCQ), in force as of 1994, is an excellent example of a modern civil code going much further, declaring good faith to be a basic principle of general application (Tetley, 2004, p. 9). For the Italian Civil Code, which states at article 1337 that “the parties, in the conduct of negotiations and the formation of the contract, shall conduct themselves according to good faith” (Tetley, 2004, p. 9), good faith is also a structural principle of general application.

A New Zealand court, in refusing to exclude from the common law of that country a general obligation for contracting parties to act in good faith in both the making and the carrying out of contracts, has held that although Lord Mansfield is long dead and buried, his spirit, promoting good faith as a basic principle, survives in many rules and principles of common law (*Livingstone v. Roskillly* [1992]). Included in the examples listed following that comment are: the rules invalidating penalty provisions, the law providing relief against forfeiture, rules providing for the importation of implied terms and the severance of ineffective terms and rules of construction such as *contra proferentem*. One might also add the general implied duty for parties to a contract to do everything they can to ensure that the object of the contract is attained (Tetley, 2004, p. 23).

At an international level, good faith and fair dealing are part of the *lex mercatoria*, the Vienna Treaty Convention of 1969, the Vienna Sales Convention of 1980 and the UNIDROIT Principles of 1994.



## 5.0 Conclusions

As authorities, experts and governments become aware of the impacts that investment arbitration decisions have on public interests issues, social and economic sustainability, and the very same legitimacy of investment protection and arbitration, concerns for the health and endurance of the arbitration system grow.

A crucial evidence of the shortcomings of the investment arbitration system are the objective and unexplained differences, between a number of investment arbitration decisions and the decisions of national courts when dealing with the same issues. The limitations of the arbitration systems are particularly clear when dealing with ex-post regulation, efficiency, transfer pricing, economic crisis, corruption and good faith.

Analyses of the gaps between the decisions of investment arbitration courts and the legal and judicial solutions of domestic national systems of law on the same issues have raised alarms about the long-term impacts of the system. The gap between common regulatory principles enacted by countries to govern the private provision of public utility principles (such as efficiency) and the decisions of arbitration courts is blatant. As a result, an increasing number of authorities have requested that gaps be closed. Among the tools to be utilized, some suggest greater reliance on general principles of law.

Comparative analysis shows that, in the regulation of public utilities, a number of principles have proven crucial to the sustainability of private provision of public utility services: regulation by law and not by contract, acceptance of ex post regulation—within certain limits—and the imposition of duties of efficiency, due diligence and good faith upon private providers.

In addition, countries should be aware that their legal position will improve if the duties of efficiency, good faith and due diligence are specifically included in their national regulatory laws, regulations and contracts.

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