

# Designing effective contracts for small-scale service providers in urban water and sanitation



Extending water and sanitation services to the urban poor will often involve contractual relationships between small-scale entrepreneurs and municipalities or utilities. The expectation is that poor communities are more likely to receive improved services when delivery is formalised under contractual agreements that provide clarity to all parties, as well as systems for enforcement of contractual obligations. This Topic Brief draws on WSUP's experience in the six-city African Cities for the Future (ACF) programme to illustrate ways of dealing with the challenges that arise when developing contracts between large and small service providers in the urban setting. The Topic Brief gives practical guidance for programme managers on how to make contracts of this type more effective and more enforceable.

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### 1. The purpose and role of contracts

The purpose of contracts is to arrive at a clear set of mutually agreed objectives through transparent negotiations. A contract articulates a means to achieve these objectives and defines performance indicators (tied to penalties or incentives). This interplay between objectives and measurement frames appropriate regulation of service delivery. Research on the formal agreements for water and sanitation partnerships in informal settlements suggests that contracts can:

*"...ensure more comprehensive negotiation and risk analysis... make development initiatives more professional, transparent and accountable... [and] address modification, conflict, withdrawal and termination."*<sup>1</sup>

Well-tailored agreements can help mitigate some risks, particularly when such agreements are developed through a participatory process and are easily understandable for all parties. Conversely, inappropriate contracts represent a risk to the sustainability of any delegated management model. Good contractual agreements are thus very important, but however polished, are only part of the story. BPD research from 2005-6, looking at the reach, regulation and business incentives of "small network operators" in Mauritania, Ghana and Mali,<sup>2</sup> reviewed how small-scale independent water operators entered into contractual arrangements with local municipalities. These providers play an increasingly recognised role in the provision of services in



poor communities, but efforts to incentivise them to expand their service and regulate their performance are not straightforward. The research concluded that, while playing a structuring role in the relationships between stakeholders, contracts are far from being the only point of reference. In fact many negotiations over extensions to the network, tariffs and quality of service took place with little, if any, reference to contracts. Perhaps in part because they were not properly negotiated in the first place, the contracts that did exist were not cast in stone and were often subject to renegotiation. In a further example from WSUP's work with partners in Kambi Muru, Nairobi –where local dynamics and individual relationships are particularly crucial– contracts are only one of the tools that will guide relationships between stakeholders. In that context, even including every possible safeguard in the contract is not going to achieve the desired goal. In this particular case, far more rests on how representative and effective the Neighbourhood Committee is.

Drawing on WSUP's experience in the ACF programme, this Topic Brief reviews the design features and role of contracts in ensuring water and sanitation service provision in poor communities, but also underscores the critical supporting factors that can make a contract effective or not. As noted above, contracts provide a space for negotiation and clarity around roles and responsibilities. Given the more informal influences of the cultural, political and accountability context, how can contracts best be strengthened and used to ensure appropriate service delivery?

### 1.1. Incentives for formalising service delivery through contracts

Several key benefits have been identified with regard to formalising the role and contribution of small-scale entrepreneurs (SEs) and community based organisations (CBOs). Analysis suggests that:

- Proactive engagement can reduce informal payments to officials and thereby lower entrepreneurs' existing costs with the savings passed on to consumers.
- More formalised approaches may more readily allow for monitoring of water quality to ensure public safety and access to ensure greater equity, and mechanisms to ensure standards and quality of service.
- Formalised relationships between authorities and small-scale providers should create greater clarity around roles and responsibilities and greater predictability and stability for their businesses or service models, thereby encouraging them to continue to invest in the sector.<sup>3</sup>

**Table 1**  
Advantages and disadvantages of contracting

Advantages of contracting	Disadvantages and challenges of contracting
<ul style="list-style-type: none"> <li>■ Can be cost-effective if there is true competition, prudent procurement procedures and qualified supervision</li> <li>■ Puts pressure on contractors to improve their efficiency</li> <li>■ May reduce authority's management burden</li> <li>■ Can support development of useful cost and performance benchmarks</li> <li>■ May provide special skills and innovative methods of operation and management</li> <li>■ Can help develop local contracting industry</li> </ul>	<ul style="list-style-type: none"> <li>■ Not cost effective if local contracting is not truly competitive</li> <li>■ Demands qualified preparation of tender documents and qualified supervision</li> <li>■ May stimulate fraud and corruption in procurement process and during supervision</li> <li>■ May meet resistance from unions</li> <li>■ May result in delays if procurement procedures are cumbersome</li> <li>■ May lower quality of service if supervision is inadequate and contractors seek to cut costs</li> <li>■ Acceptance of low bids may lead to inferior quality of work</li> </ul>

Table adapted from Lorentzen (1998)<sup>4</sup>

There are various advantages and disadvantages to contracting and each party is likely to have different incentives (see Table 1). Understanding the profile and incentives of the contracting parties should provide clues as to whether they will respect the contract and seriously strive to deliver on their contractual commitments (see Table 2). The contractor's accountability may vary depending on whether they live in the area or are investors from a distance.

**Table 2**  
Possible motivations for formalising contracts with small-scale providers

Small-scale provider	Municipality	Utility
<ul style="list-style-type: none"> <li>■ Could enable access to formal financing that helps expand the business</li> <li>■ Formal acknowledgment of SE's role in water and sanitation market could lead to activities and investments in other related sectors</li> <li>■ Could offer business stability and legal protection that can protect SE's investments and lengthen their investment horizons</li> <li>■ Could provide greater stability and predictability compared to instability often associated with licensing (where the issuing of licenses is prey to political change)</li> </ul>	<ul style="list-style-type: none"> <li>■ Extended decision-making and control over the water and sanitation market (ability to allocate market share in a balanced manner that cross-subsidises between profitable and not-profitable; power to set prices)</li> <li>■ Contract award or rejection provides means to favour some SEs over others based on performance (or indeed other less transparent criteria)</li> <li>■ Could lead to increased income through taxes or other fees</li> <li>■ Reinforced control over water and service quality</li> </ul>	<ul style="list-style-type: none"> <li>■ Permits the 'outsourcing' of loss-making customers (lowering the utility's costs) while SEs remain profitable given lower overhead costs</li> <li>■ SEs may be more responsive managers, particularly in low-income contexts as they are 'closer to the field' (so may be quicker to be paid by otherwise 'reluctant' consumers and may be faster at detecting and repairing leaks, etc.)</li> </ul>

Recognising the incentives for different stakeholders to formalise contracts with small providers is only half of the required analysis. A key piece of the puzzle is understanding why various stakeholders might not want to formalise agreements. This recognition will foster a clearer and hopefully more direct dialogue between stakeholders. Such disincentives are noted in Table 3 below:

**Table 3**  
Possible disincentives for formalising contracts

Small-scale provider	Municipality	Utility
<ul style="list-style-type: none"> <li>■ Fear of losing their assets and/or business due to loss of contract, regulatory impositions, etc.</li> <li>■ Loss of flexibility in setting prices, technology choice, etc.</li> <li>■ Can result in added costs (in the form of bribes, requirements for formal accounting, higher quality requirements, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>■ Control over price and quality is possible only if real oversight capacity exists</li> <li>■ May see SEs as opportunists or rent seekers rather than legitimate service providers</li> <li>■ Franchisees prove unreliable, unable to guarantee maintenance of water systems</li> <li>■ 'Outsourcing' renders population less dependent on local officials and their favours</li> </ul>	<ul style="list-style-type: none"> <li>■ Vendors may use political and other connections to resist reform once established</li> <li>■ Licensing systems can become rigid, effectively barring any new entries into the market</li> <li>■ Contract may commit utilities to a certain quality of bulk provision which they may not be able to achieve in reality. At worst this can open them up to litigation over breach of contract (at best, it makes their non-delivery more transparent)</li> </ul>

### 1.2. Different agreements for different contracting parties

The contract modalities between small water providers and municipalities or utilities are diverse, spanning both service and product delivery. In some cases the utility or municipality directly subcontracts a private commercial operator. In others, delegated management of the operators lies with community-based organisations, which in

“ Allocation of risk has to be measured against the ability of smaller companies to manage it ”

turn sub-contract to private operators. These arrangements are usually framed by other formal agreements such as Memorandums of Understanding.

One emerging area of WSUP learning refers to the difference in contract needs for different contracted parties: for example, between a small business and a community-managed scheme. Some small businesses are experienced and conversant with legal contracts. However, particularly for CBOs, a different approach might be needed. Experience with CBOs has suggested that the contracting process between CBOs and municipalities/utilities, or between CBOs and small-scale entrepreneurs, is often longer and requires a certain degree of flexibility which allows for a staged or sequenced approach. Contract negotiations with CBOs often require extensive consultation, better articulation of (and frequent reference to) the contract terms, and improved planning for achievable business models.

As profits are presumably not their main aim, contracts with CBOs -like those in Maputo- can also more easily incorporate public policy or socially-minded goals dealing with safeguarding access for the poorest, or with hygiene and cleanliness targets. While this additional effort may not be conducive to tight project timelines, getting the contract right is in the interest of both parties. As experience has shown, overly ambitious targets and poor planning have caused small-scale entrepreneurs to fail in their contractual obligations or resulted in relations breaking down between CBO/communities and the municipality and/or utility. Interestingly, WSUP has included clauses dealing with amicable resolution in these agreements with CBOs versus more traditional dispute resolution through arbitration or adjudication in contracts with private providers. There is considerable flexibility embedded in these contracts since the parties are able to “amend or supplement” the contract at “any time in writing” with their common agreement.

With regard to risk, experience is evolving but generally the sense from WSUP practitioners is that CBO risk must be minimised and absorbed by the utility. Allocation of risk then has to be measured against the ability of the smaller companies to manage it but also weighed up against whether a utility wants to incentivise these smaller companies to grow. Experience in Mozambique and Madagascar -where there is a high risk of boreholes not being viable even after feasibility studies- suggests the risk should be owned and managed by the drilling company rather than passed onto the small-scale operator.

Essentially the aim is to create a dialogue relevant to the contract negotiations on roles and responsibilities. In line with these efforts, some analysis needs to be done of the likely enforcement of the contracts. Who would hold the contractor to account? If accessible -in case of failure- a claims court may be appropriate for a contract relating to construction of facilities where building standards are easily enforceable, but perhaps less so for a CBO contracted for service provision.

Nevertheless, contracts or agreements are only one element in a complex process. In various cases in the literature, the emphasis appears to have been on creating the perfect contract without 1) understanding how contextual factors shape each contracting party's likely strategies, capacities and risks; 2) considering where flexibility is likely to be needed given an evolving context; and 3) understanding how to create on-going communications between the parties to resolve the inevitable differences in interpretation.

**“Don’t worry, it’s only an MOU”**

Contracting parties may want to be careful about their use of language. In many jurisdictions, a Memorandum of Understanding (MOU) may, in fact, be binding and legally enforceable in court. Generally, if participants make real commitments to each other with the intention to be bound, those commitments are binding

and recognised in law. A legal and binding contract may be created even if the document containing the commitments is referred to as an ‘MOU’. If participants do not want to be bound to a document that summarises negotiations or undertakings, it is best to state this directly and provide an alternative in those areas.<sup>a</sup>

**Licensing vs. Contracting**

In some places, licensing rather than contracting might be used to formalise the service provision of small enterprises. Licensing may not necessarily be objective-driven but may be a default option. Also licenses may be issued by non-related offices within the government administration, like the small business unit of a municipality. In Maputo, licensing seems easier than contracting for SEs that have self-financed their investment.

However, licensing remains challenging if SEs are asked to upgrade the service. The quality standards for potable water would force some SEs to close down since the cost of compliance would be too high relative to their incomes. In cases where SEs still operate without complying with the rules, the public authority has neither licensed them nor closed the boreholes because it cannot provide an alternative in those areas.

<sup>a</sup> See WSUP Topic Brief entitled *Recognising and dealing with informal influences in water and sanitation services delivery*, July 2012, for further analysis on the influence of more subtle informal factors, such as conventions, norms of behaviour, and unwritten cultural codes of conduct. This Topic Brief also touches on the timeframes and procedures to file claims.

**1.3. Wider influencing factors beyond water and sanitation**

As noted above, a range of factors can influence the effectiveness of contracts. Many of these will be well beyond the control of water and sanitation professionals. This section considers the various challenges to contracting that require some understanding and analysis:

- **Cultural views and behavioural aspects:** In some cultures, a contract signals the beginning of a conversation whereby there is the expectation that after a reasonable period of time and as more information becomes available, it will –as a matter of course– be renegotiated. In other cultures, the contract signals the *end* of a conversation and thereby the expectation is that renegotiation shall only take place in the event of failure or completion. Recognising that such renegotiation may be necessary, contracts with CBOs in Ghana have been kept to a short two years. Such a short timeframe may not however give small-scale providers the confidence to invest further to improve and expand the infrastructure and their services. Where such improvements and expansion are not expected (for example in the Franchise Agreement for Management of Public Toilets at Kotei Sub Metro Council in Kumasi, Ghana), then the duration of the agreement may be less important. Furthermore, the institutional contracting party (utility, municipality) may prefer shorter contracts, because of expectations of declining performance by small-scale providers.
- **Legal environment and ease of enforcement:** Given that contracts are a legally binding document, the regulatory and enforcement environment must be considered. Processing a legal claim is highly variable from country to country and may require significant time, cost and effort.<sup>a</sup> While the factors that affect contract enforcement are multiple, experience suggests that challenging political situations and the level of decentralisation can shape each party’s incentives to enter into a contract at the outset, but also their ability to restructure contracts, assign penalties or otherwise hold signatories to account. It would be useful for water and sanitation sector

“A contract is only as good as the contracting party’s ability to enforce it”

professionals to look to other sectors (e.g. transport or health) to see whether there are any aspects to contracting around design and enforcement that would inform service delivery.

- **Lack of capacity for enforcement:** Resource constraints of utilities and municipalities can mean that they are not engaged or able to enforce contractual agreements. For example, in Maputo the water utility held a contract with a private operator to provide water services. However, resources were not available to ensure the operator complied with the terms and deadlines of the contract agreement. In Kumasi, much of the role of enforcement around sanitation falls to Environmental Health Officers who also have the task of overseeing a range of other public health and environmental issues. Limited resources, training and capacity are therefore significant, but other factors are also important. Political interference may point more to an inability to enforce rather than a lack of capacity. The lack of a connection between the different government departments responsible for issuing contracts and enforcing these may also hinder enforcement. Thus a contract is only as good as the contracting party’s ability to enforce it.
- **Credit and financing:** Efforts to work with and through small-scale operators and businesses may require not only support around contracting processes; they may also require support to overcome a lack of access to finance and credit. This might mean working with local financial institutions or small business development units within local government, or twinning through local Chambers of Commerce, or other mechanisms.

## 2. Considerations regarding contract content

As part of the ACF learning process around contracting in urban settings, a checklist emerged of essential and desirable characteristics of a ‘good contract’, as per Table 4 below:

Table 4  
“Good Contract”  
checklist

Essential	Desirable
<ul style="list-style-type: none"> <li>■ Legally binding formal agreement</li> </ul>	<ul style="list-style-type: none"> <li>■ Acts as a platform to frame contractual negotiations.</li> <li>■ Participatory - the contract terms and ‘conversation’ are initiated early on in the process (builds engagement, better understanding of risks, eventualities).</li> <li>■ Avoids conflicts.</li> </ul>
<ul style="list-style-type: none"> <li>■ Reference point in case of failure</li> </ul>	<ul style="list-style-type: none"> <li>■ Working document for on-going reference.</li> <li>■ Control tool for quality assurance, monitoring and evaluation.</li> </ul>
<ul style="list-style-type: none"> <li>■ Defines and clarifies roles and responsibilities, obligations</li> </ul>	<ul style="list-style-type: none"> <li>■ Allocates appropriate roles and responsibilities, and sets fair level of risk for all parties. Takes into account the context and influencing factors.</li> <li>■ Allocates appropriate risk to contract owner in the municipality or utility to encourage ownership.</li> </ul>
<ul style="list-style-type: none"> <li>■ Gives clarity on the terms of engagement</li> </ul>	<ul style="list-style-type: none"> <li>■ Builds engagement and commitment with contracted parties and sends appropriate signals through the terms and length of the contract.</li> <li>■ Transparency and accountability.</li> <li>■ Exit strategy terms and conditions are clearly stated.</li> </ul>
<ul style="list-style-type: none"> <li>■ Language - legal document in official languages.</li> </ul>	<ul style="list-style-type: none"> <li>■ Written in language that is legally binding but also easy to understand for both parties - definition of terms explained in a manner for all parties to understand.</li> </ul>
<ul style="list-style-type: none"> <li>■ States deliverables and deadlines</li> </ul>	<ul style="list-style-type: none"> <li>■ Has appropriate level of flexibility for deliverables and deadlines for contracted parties. Incorporates sufficient flexibility without ambiguity.</li> </ul>

**Table 5**  
Designing contracts between SEs and municipalities/utilities

From the perspective of the municipality or utility, there are numerous questions to consider around designing contracts. Table 5 below indicates some of these:

SE - Municipality	SE - Utility
<ul style="list-style-type: none"> <li>■ Does the municipality have the capacity and technical know-how to monitor the contract and the quality of the service?</li> <li>■ What guarantees does the municipality need to provide to the service provider?</li> <li>■ Do contracts protect SEs if their performance/revenues worsen due to issues beyond their control, for instance changes in user demand that might be a function of municipal actions?</li> <li>■ What is the municipality's true ability to curb prejudicial behaviours (from its staff or its voters or others)?</li> <li>■ What is the relationship, if any, between the contract length and the municipal mandate? What is the life expectancy of SEs? Is 'evolution' of the contract foreseen? How are revisions made?</li> <li>■ How can/should performance indicators include wider public sector or municipal public policy goals?</li> </ul>	<ul style="list-style-type: none"> <li>■ How do SE targets relate to those of the utility?</li> <li>■ Are the service delivery boundaries for the SE defined and under what circumstances can they be changed?</li> <li>■ Who controls tariff setting and with what formulas?</li> <li>■ Do contracts protect the SE from cost changes caused by changes in utility provision (e.g. if there is a decline in service quality or a shift in the utility's strategy)?</li> <li>■ Has there been transparency about when the utility is likely to extend services into the SE area? How will their assets and infrastructure be incorporated into that of the utility?</li> <li>■ What is the life expectancy of SEs? Are they expected to play only a temporary role in service delivery?</li> </ul>

Contracting parties may seek to have contracts help to fulfil a variety of functions beyond purely service delivery. Below are some examples of contract elements that require consideration.

- **Requirement to provide information:** Information may be needed by government officials to determine or refine policies and approaches. In such cases the small-scale entrepreneur or community-based organisation should be incentivised to provide information to help government officials understand how best to create incentives that spur further investment or greater effectiveness.
- **Investment/customer capture:** Assurance will be needed by the contracting party that their investments will not be captured by the authorities, causing small-scale entrepreneurs to minimise their level of investment. The timeframe or other terms in the contract may need to provide some reassurance to the contracting party. On the other hand, there is a risk of customer capture by SEs, as there may be no alternative to the services they are providing. The contract may then wish to introduce a cap on tariffs.
- **Language:** In cases where the contracted party may be unfamiliar with the language of official documents, generating engagement and ownership is essential. Differences in official and local languages compounded by the complexity of legal, financial or technical terminology can undermine relationships quite quickly. WSUP project managers highlight the need to use simple and clear language to create a contract that is genuinely understood and accepted by all contracting parties. Contracts used in Naivasha, for example, between Naivawass (the public utility) and private borehole operators in surrounding communities, were only a few pages long and were carefully but simply drafted.
- **Unforeseen circumstances, evolving roles and responsibilities:** In cases where various unknowns suggest that roles and responsibilities will have to evolve, then contracts need to find a way to reflect this with expected renegotiations

## “ Contracts should incorporate clauses for dealing with unforeseen circumstances fairly ”

at various intervals or at specific points. As noted above, design of such arrangements should also take into account whether the contracted party is the community or a private provider. Thus contracts should incorporate flexibility, not ambiguity, by including a clause or clauses for dealing with evolving and unforeseen circumstances fairly. A WSUP ACF case in Mali, for example, saw a contractor struggling to set aside a certain amount of money per standpipe for maintenance because the standpipes were not returning the expected revenue. A similar case happened in Madagascar where insufficient demand for SanPlat latrines left the provider with insufficient revenue. The recommendation for the future was to ensure a more comprehensive financial and business model prior to signing the contract. Thus contracting should be part of a longer process of engaging small providers around their business prospects.

- **Monitoring and evaluation:** Indicators should be mutually agreed and serve as sufficient signals to warn all parties of any need for adjustment. They should be easy to interpret, not too numerous and the data required to measure them should be inexpensive and easy to collect and use. In the case of service provision contracts, a monitoring and evaluation strategy can ensure the contract is considered as a relevant reference tool for both parties. Clear articulation of the monitoring steps, sanctions and exit strategy may also support compliance. In the case of Kambi Muru in Nairobi, it was recommended that the role of the Neighbourhood Committee (NC) be written into agreements between the operator and the utility with details of the oversight procedure, oversight criteria, the frequency of controls, penalties/bonuses according to level of completion of the objectives, revenue to pay to the NC, etc.

### 3. Recommendations for programme managers

- **Localise the contract:** Although seemingly obvious, off-the-shelf contracts are more often problematic than not. Tailoring the contract to the local context is critical. This includes determining at what stage of the process to initiate discussions around formal agreements. The incentives and needs of the contracting parties should be considered, in terms of how these may impact on language, content, level of flexibility required, etc.
- **Flexibility not ambiguity:** There is often a sense that allowing for flexibility reduces the strength of a contract. But in fact, a specific clause that clearly indicates where negotiations are likely to continue even after the contract has been signed can in fact reduce ambiguity, help to manage expectations, and create more appropriate dialogue between the contracting parties. The aim should be to mutually agree upon a workable framework to manage unforeseen circumstances.
- **Workable contracts:** Strong contracts depend upon the full engagement of the signatories, and as sense of ownership on both sides. There is inevitably a trade-off between the extent of formalisation of contracting and the level of costs for the stakeholders: high levels of detail require time and money. But good contract design with simple language, adequate flexibility and appropriately assigned tasks (with clear roles, responsibilities and deliverables) can go a long way towards strengthening the contract and generating a useful working document for both parties.
- **Enforceable contracts:** Making contracts more enforceable is complex, as in many instances the issues that will determine their success or failure are beyond the control of the stakeholders, and framed in wider legal, political and other factors. This said, contracts grounded in the legal environment –with clearly articulated monitoring and sanctions, solid and straightforward procurement processes, and incentives that lead to efficiencies– are a step in the right direction.
- **Build local capacity:** In many instances, contracting mechanisms have been proposed by outside actors. A question remains about whether such practices



“ Making contracts workable is a trade-off between detail and flexibility ”

remain viable once the involvement of the outside actor (e.g. NGO or donor) ceases. However, contracts that are mutually supportive of the contracted parties' incentives and capacities may help ensure that services are sustained. Furthermore, if the goal is to improve service delivery, perhaps other options (such as training, capacity building and the promotion of dialogue) can also contribute towards this, providing some sense of “public service” among stakeholders. All stakeholders need to understand the purpose and form of regulation in the provision of water and sanitation services generally, and the significance of their role in each specific context: refer to the Kambi Muru case study for a useful example of this.

Ultimately, it may be difficult to design contracts that are completely beyond the reach of outside influences, such as a new mayor trying to put his or her stamp on the system; or changes in the social context, or in regulations and policies; or different interpretations of whether targets have been met, particularly if they involve infrastructure hidden underground. Similarly, many contracts are in theory aimed at building the capacity of local parties, but in fact lack the balance and communication between signatories to ensure that the more powerful party does not manipulate the situation. WSUP's own work has been very much about institutionalising and embedding best practice around contracting in an effort to avoid such influences.

While stressing that in many cultures the contract is not the final word, the process of elaborating and negotiating a contract needs to include an early, and then on-going, dialogue amongst the parties. When building the capacity of service providers, whether CBOs or small businesses, making contracts workable and enforceable is a trade-off between achieving the necessary level of detail and ensuring adequate flexibility to manage unforeseen circumstances. The lessons learned under the ACF programme suggest that even if a contract does not cover all eventualities, contracts are a necessary stage of the engagement process and provide an important legal backstop.

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