

EAP Task Force

Document 11

Joint Meeting of the EU Water Initiative's EECCA Working Group and the EAP Task Force Environmental Finance and Water Networks

29 March –1 April 2005, Chisinau, Moldova

Outline of the Background Paper on Reforms in the Municipal Sector in EECCA

Participants are invited to take note of the document and to provide their comments on its content. In particular delegates are invited to provide their views on the key messages contained in the document and to highlight any country examples of institutional and legal reforms that they would wish the secretariat to include in the document when it will be developed into its full length.

ACTION REQUIRED: For information and discussion.

1 Objectives of the discussion

This paper focuses on some of the key issues in the relationship between utilities and municipalities that contribute to the current ineffectiveness of the water supply and sanitation (WSS) sector. The paper also provides proposals on how these local-level obstacles to an improvement of the effectiveness of the sector could be overcome. This is a first draft to generate a debate in the Chisinau meeting, and the language that is being used may not be as polished as it would be in the final version. The full background paper will be prepared by the EAP Task Force secretariat and presented at the second preparatory meeting on 6 June in London. The full paper is intended to support the Ministers discussion on these issues at the Ministerial consultations of EECCA Ministers of Finance/Economy and Environment and their OECD partners on WSS sector reform in Moscow, in November 2005.

2 Key issues

The *Almaty Guiding Principles* suggested that responsibility for providing water supply and sanitation services should be transferred to municipalities. This requires that local governments develop capacity to exert regulatory oversight of the sector. The Guiding Principles also recommend that the roles of local governments and water utilities should be clarified, and that utilities should be established as autonomous, commercially-run entities.

While most EECCA countries have decentralised responsibility for water supply and sanitation infrastructure to the municipal level early-on in the reform process, these actions were frequently taken *without appropriate changes* to the institutional set-up, organisational structure and management, of the sector. Some of the key problems that resulted from the decentralisation process are:

- after the transfer of ownership of the communal infrastructure from national to local/regional level the property was often not evaluated and/or property rights were not properly registered;
- local/regional public authorities as well as utilities lack strategic planning capacity for the communal services infrastructure;
- responsibilities of municipalities and of utilities operating different parts of the infrastructure (e.g. water and district heating) were not clearly or properly defined, and contractual relations between the public administrations and the utilities, as well as between the utilities were not properly set-up;
- due to the lack of adequate regulation and tariff setting rules and procedures at national, regional and local levels, the tariff setting in EECCA has often become a highly politicised process, dependent on short term political agendas and *ad hoc* discretionary decisions.

While some of these problems stem from a lack of reform of the overall regulatory framework for the water sector, many of them can be tackled through measures that could be implemented at the local level. In fact many sector experts think that some of the key reforms that need to be undertaken have to be implemented at that level. The following sections highlight three of the areas where reforms are needed.

2.1 Improving strategic planning and allocating sufficient public funds for the sector

Most municipalities and utilities in EECCA still lack strategic planning capacity. Only few municipalities in EECCA have updated or developed City Master plans, including infrastructure development and demand management plans, or set goals for the quantity and quality of communal services that they want to attain. Very few municipalities have pilot-tested multi-year investment planning, as well as only few utilities have developed corporate development or strategic business plans (usually, such utilities are

involved in projects financed by IFIs). Municipalities and utilities often *lack accurate data* for a sound planning due to weaknesses in the information management, reporting and monitoring systems.

As owners of the communal services infrastructure, municipalities are responsible for its rehabilitation, modernisation and development. But most municipalities in EECCA do not have sufficient funds to carry-out these responsibilities, because they are not financially autonomous or sustainable. Rather the municipalities are still largely dependent on fiscal transfers from central or regional budgets. For that reason they often have to co-ordinate their infrastructure development plans and capital expenditure budgets with national/regional plans and budgets. This makes the strategic planning at local level dependent on the politics at the national/regional level and generates a risk that local investment plans will not be implemented due to budget constraints.

In addition, the funds that are available at the local level are often not used effectively or efficiently. The current system offers weak incentives to sub-national levels of government for responsible, long-term management and the development of new infrastructure for the environment. All revenues and expenditures are allocated annually through year-long financial plans. Neither a long-term vision of investment needs nor a forecast of the municipality's future financial situation exist. The budget classification system was not designed with the particular needs of local government in mind. The budget preparation and monitoring system is not task- or result-oriented but rather is just focused on spending money in accordance with specified budget lines. Investment planning for municipal infrastructure is discretionary and focused not only on short-term outputs, but also on priorities which are often too numerous and too volatile. There are no clear and transparent criteria for appraising and prioritizing investment projects that will be financed from municipal budgets.

There is therefore a need to develop capacity in the use of local expenditure management and investment planning tools, such as mid-term budget framework (3-5 years) for preparing transparent and task-oriented annual budgets and capital improvement plans. The lack of such tools undermines the investment potential of municipalities to leverage domestic and foreign finance to municipal investments.

2.2 Reforming the relationship between municipalities and water utilities

One of the impediments to the success of commercially-oriented management of water utilities (be they managed and/or owned under a public or private framework) has been the sometimes intense and conflicting linkages between the utilities and the municipal leadership. In these cases, the absence of a clear definition of the roles of water utilities and those of the municipality hampers the independent management of utilities. Furthermore, in the absence of monitorable performance targets and performance-based remuneration utilities have little or no incentives to manage their operations effectively and efficiently.

The development of performance-based contracts between utilities and municipalities is one possible way forward, which is also recommended in the Almaty Guiding Principles. Generally, performance-based contracting consists of an instrument designed to help define sector development goals and resources, and lay out the roles that government institutions should play in order to reach them. In particular, these contracts impose strict time-bound performance targets to be achieved by the operators in exchange for increased autonomy of the operator. Performance targets include the level and quality of service, management and operational efficiency, financial and investment requirements, and institutional improvement. As with any agreement, such a contract should be the outcome of a shared vision between the government and the utility of what these services should become, which in turn will define the resources and the financing needed to reach them (this includes the development of a long-term tariff strategy).

Performance-based contracts can also be instrumental in addressing one other important failure of the sector: the accountability and transparency of the sector. The development of such contracts necessitates the creation of effective performance monitoring systems to provide a solid data base for decision-making. Transparency is also a key asset when it comes to communicating major changes, such as tariff increases or extensions of infrastructure to the general public.

International aid agencies and donors can be instrumental in providing financial and technical assistance to help frame these agreements on solid principles and in sharing their broad experience with similar types of contracts in other countries and sectors.

2.3 Improving utility management

At the utility level, management practices can often be substantially improved. This includes, general management issues (contracting, accounting practice and financial management, billing and collection of user charges, customers service and demand management, etc.), numerous technical issues (hydraulic regulation, leaks detection and prevention, improving energy efficiency, etc.) as well as the effective use of relevant managerial tools: for accounting, financial and investment planning, for hydraulic modelling, energy balance and water mass balance, energy and water audit, etc.

The problem could be addressed by a combination of internal capacity development and attracting external management and technical expertise, including from the private sector. This could be achieved by granting utilities more autonomous management and a simultaneous exposure to competition where this is possible.

Despite official declarations to promote private sector participation (PSP) in many EECCA countries, the overall role of private firms in the sector remains marginal. Exceptions are Armenia and the Russian Federation. In Russia, domestic private operators are now serving about 8% of the urban population. While this is encouraging, it is clear that the involvement of the private sector in the management of water utilities will only be sustained if the water sector becomes more predictable economically and politically, and if consumers are sufficiently protected from abuse of monopoly power. International as well as domestic private sector operators are currently testing the market, and they might withdraw as quickly as they have appeared. A key obstacle to the commercialization of water utility management is the lack of capacity in municipalities to regulate and oversee these entities. Sometimes, municipalities have an interest to maintain un-transparency due to the discretion over cash-flows that it provides them with.

While private operators would bring valuable management and technical expertise, the role of the private sector in providing finance to the EECCA water sector seems less likely to grow in the short and medium term. International operators are sensible to the overall investment climate, as well as to regulatory and political risks, which are currently unfavorable in EECCA. Recent years have also brought with them a more risk-averse attitude in water sector companies, following a string of failed contracts in Latin America and Asia. The development of risk mitigation instruments and of local financial and capital markets might however help to overcome this obstacle.

3 Relevant Task Force and Project Preparation Committee products

The following Task Force and PPC inputs will be used to develop the report:

- Survey of water sector institutional and legal reforms in 6 EECCA countries (internal working papers);
- The Guideline for the Performance-Based contract;
- Country papers on Local credit markets (internal working papers);
- Overview of domestic and international private companies operating in the utilities sector in the Russian Federation;
- EECCA Governments' strategies for municipal sector reform - based on legal texts available in these countries;
- Restructuring of Russian Housing and Communal Services Sector (National Foundation for Housing Reform, Gosstroy Russia/ World Bank, 2003)
- Relevant chapters from the Feasibility studies in communal services sector prepared for EBRD and WB projects in EECCA municipalities and the EBRD work on enhancing creditworthiness of the municipalities in EECCA (assuming that the EBRD and the WB could make them available).

4 Possible issues for discussion and next steps

Ministers would be invited to discuss the following issues during their consultations:

- How can efforts to strengthen local level capacity, and to reform the relations between local governments and utilities be scaled-up effectively? What are the mechanisms and incentives that could be used to support utilities and municipalities in this effort?
- What are the opportunities and obstacles for private sector participation, and what are the measures that would need to be undertaken to utilize the full potential that this option represents, while protecting the interests of consumers?