

# Executive summary

Water supply and sanitation services have remarkably improved in Estonia, in terms of share of the population connected to a service and quality of service provision. Over the last two decades, investments to achieve the current level of quality benefitted from significant financial support from the European Commission, of which the Estonian government was able to make the best use.

The services are now facing new challenges: additional investments are required to keep up with social expectations and environmental and health regulations; additional funding is needed to operate, maintain and potentially renew assets financed through EU grants. These needs must be met at a time when downward demographic trends will affect revenues from utilities. Moreover, EU funding for water supply and sanitation services will be gradually be phased out.

It is clear that current and future investment and financing needs can only be met if substantial efficiency gains are achieved, in a sector that remains highly fragmented (177 water companies were operating in Estonia in 2018; 44 local governments are serviced by more than one water company). Business-as-usual is not an option, as delaying reform can only lead to decaying of assets, jeopardising service quality and dramatically raising the cost of rehabilitation and service provision later on.

The Estonian Ministry of Environment called on DG Reform and the OECD to contribute to making the case for reform, while exploring practical ways forward. The process included in-depth analyses of a series of issues, in particular in relation to tariff setting, economic regulation of the sector, and legal provisions. The process entailed recurrent consultation with stakeholders as well, including national authorities (the Competition Board, the Ministry of Finance), local authorities and utilities, and national experts. The project was informed by lessons from similar endeavours in Europe and beyond.

Consolidation of utilities is acknowledged by all stakeholders as a practical way forward to deliver substantial efficiency gains, for operations and investment. However, over the last decade, efforts in this direction have been hampered by concerns that i) smaller municipalities will not have their voices heard in merged utilities, and ii) customers of well-managed utilities will lose, as they would have to pay higher water bills to absorb less cost-effective ones. These concerns are serious. They need to be addressed, if the Estonian ministry favours a voluntary dynamics towards consolidation.

The recommendations developed in the course of the project allow addressing both concerns, in line with the Ministry's preference for a voluntary approach. First, consolidation can take several forms. Merger on a geographical basis is only one of them. Discussions with stakeholders have made the case for the mutualisation of functions as a practical way forward that can build trust across service providers and lead to more ambitious coordination, all the way towards coordinated development and investment. Governance arrangements were discussed at utility level, which support both the capacity to make decisions and the need to hear the voices of diverse local authorities.

Second, several actions are required to make the best of existing opportunities to incentivise – including financially - municipalities and utilities to move towards some form of consolidation. One set of actions consists in providing financial incentives to utilities. In the Estonian context, this can be done in two ways: i) accelerated depreciation of assets under conditions to be agreed upon by the economic regulator and

the Ministry of Environment; and ii) reward utilities that explore ambitious options to enhance the efficacy of development plans, including through some form of consolidation. Stakeholder consultations have explored practical options, including through the Estonian Environmental Investment Centre.

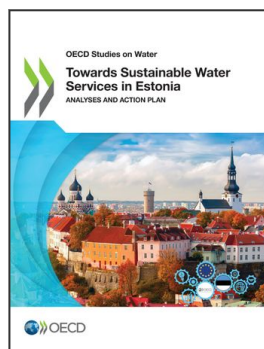
Another set of actions relate to reviewing and assessing the opportunity of investments and expenditure programmes developed by local authorities and service providers.

Benchmarking can play an important role, to set performance objectives and review performance of water companies. In the course of the project, a benchmarking process was proposed, which goes beyond the comparison of costs and includes the comparison of levels of performance and the ambition of development plans in terms of efficiency gains. More broadly, transparency of performance can support a consolidation process, while contributing to stakeholder engagement.

Implementation of these recommendations requires strong coordination between the Ministry of environment, which sets policy objectives and levels of ambition, and the economic regulator – the Competition Board – which defines the tariff setting methodology and can arrange the adequate combination of benchmarking and reward. Stakeholder consultations throughout the project also emphasised the role of other government agencies (Ministry of finance), local authorities and utilities (individually and collectively). Training material was developed on issues discussed in the course of the project, to further strengthen capacities of the key partners.

It is noteworthy that the Ministry has the capacity to set targets and a deadline for a move towards some form of consolidation. Should such targets not be met ahead of the set deadline, a more top-down approach could be considered.

On these and related issues, experience sharing among Baltic states and across Europe can be a source of inspiration. An international workshop in the course of the project revealed the breadth and depth of experience with forms of consolidation for water supply and sanitation service provision, both in terms of end point and in terms of processes for getting there. Estonia has a lot to share, building on recent experience and the on-going reform. This confirms the distinctive value added of peer learning supported by DG Reform.



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