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An action-oriented strategy and an action plan to carry out reform

An action-oriented strategy brings the threads together. It recapitulates the case for reform, essentially claiming that business-as-usual is not an option and the time for reform is now. It captures the main elements of a voluntary reform. It is supported by an action plan, which offers a sequence of reforms (from urgent to medium-term action) and allocates responsibilities across stakeholders.

7.1. Background and objectives

The Ministry of the Environment of Estonia jointly with other governmental authorities (the Ministry of Finance, the Minister of Public Administration), the European Commission – DG Reform, and the OECD are partnering to enhance the sustainability of water supply and sanitation services in Estonia. The Project will support the preparation of a roadmap for the consolidation of the water utility sector, a requisite for a sustainable and socially acceptable financing strategy and a broader water sector reform in Estonia. See the Detailed Project Description, for more information on background, scope and process.

The specific objectives of this Project are:

- to support the initiatives of national authorities to design their reforms according to their priorities, taking into account initial conditions and expected socio-economic impacts
- to support the efforts of national authorities to define and implement appropriate processes and methodologies by taking into account good practices of and lessons learned by other countries in addressing similar situations
- to assist the national authorities and water utilities in enhancing the efficiency and effectiveness of human-resource management, inter alia, by strengthening professional knowledge and skills and setting out clear responsibilities.

This action-oriented strategy draws the threads together and offers a structured and sequenced approach to implement the recommendations offered in previous chapters. Some of the key actions to be considered relate to the points:

- Making the case for reform
- Scenarios for the aggregation of water utilities in Estonia
- Incentives to foster consolidation of utilities
- Technical – including legal - issues to be tackled
- Tariff policy and methodology
- Independent economic regulation for WSS.

The strategy is supplemented by an action plan, which devolves responsibilities to specific stakeholders, based on OECD Secretariat's understanding of respective competences and capabilities. The strategy and the action plan benefitted from feedback from stakeholders.

The strategy and the action plan would benefit from increased resources at the Ministry of Environment, the Competition Authority and the Estonian Environmental Investment Centre. Institutional reforms in 2022 suggest that the Competition Authority now has the capacity to generate the resources required to play its role in the suggested strategy. The note suggests options to secure funding for the Centre. The capacities of the Ministry would need to be increased, in particular in terms of staffing: the necessary engagement with stakeholders, the development of much needed guidance and practical support require time. Considering the massive benefits of an action plan designed to set the water supply and sanitation sector on a path towards performance and financial sustainability, this would be public money well spent.

7.2. Make the case for reform

Estonia has achieved a remarkable rate of construction of infrastructures for water and sanitation services, since its accession to the European Union, with multiple benefits for the population. Financing these assets has essentially relied on EU funding. These assets need to be properly operated and maintained. Failure to do so will lead to a rapid decay and a need to rebuild existing assets, putting human health and freshwater ecosystems at risk and adding costs to the community.

To date, the water supply and sanitation industry in Estonia is highly diverse and fragmented. While some services have gained experience in consolidation, 177 water companies were operating in Estonia in 2018; 44 local governments are serviced by more than one water company.

This fragmentation, and the limited size of multiple service providers, hinder the industry's financial capacity to operate, maintain and renew existing assets. Some service providers operate several services (e.g. district heating) and the water service may be subsidised by revenues from other services. In other cases, lack of financial resources leads to postponing investment decisions to renew existing assets, potentially affecting service quality now and in the future, and risking a rapid decay of assets, which then will have to be rebuilt sooner than initially needed, merely increasing needs and creating future liabilities. The current crisis triggered by energy prices illustrates how fragile the industry is in Estonia.

The consequences in terms of quality of service are already visible, as the industry faces issues of compliance with the EU regulation. Five wastewater treatment plants (WWTP) of more than 2,000 population equivalent (pe) fail to comply with the Urban Wastewater Treatment Directive (UWWTD). Several WWTP of less than 2,000 pe – too small to fall within the scope of the UWWTD – release poorly treated wastewater, potentially affecting compliance with national requirements (which are driven by the Baltic Marine Environment Protection Commission – HELCOM).

In the future, demographic trends will further exacerbate financial challenges for water services. While the national population is projected to decline by 2.7% by 2045, population in four counties is projected to decline by 1/3, with negative consequences on water demand and the revenues of water services.

In that context, the prevailing financing model for water and sanitation services in Estonia is obsolete:

- EU funds, which represent 85% of capital expenditures, will gradually be phased out and
- the Estonian Ministry of Finance confirmed that domestic public finance will not be a substitute.

Municipalities and utilities need to acknowledge that they should – rapidly - transition towards a model where they are financially sustainable, for OPEX and CAPEX. This can only result from a combination of 2 lines of action:

- Increase revenues from user tariffs. There is some room for manoeuvre. OECD analyses for DG Environment in 2020 and comparison across 27 EU member states suggest that 90% of the population can afford to pay more for water services. As is often the case, keeping water tariffs low hurts the poor as it deprives water utilities from the revenue they need to operate, maintain and extend services. In a country like Estonia, affordability issues would be much more effectively addressed through targeted social measures than through water bill measures.
- Deliver substantial efficiency gains, at both operational and investment level. Considering the operational costs of water utilities, operational efficiency can result from streamlining labour, enhancing energy efficiency, or increasing the efficiency of networks. It is noteworthy that most of these measures require some initial investment to deliver medium or long-term benefits. Efficiency at investment level requires robust planning and sequencing of investment. While utilities can enhance the relevance and robustness of development plans, there are limits to what can be achieved at utility level: rooms for manoeuvre expand significantly when development plans explore opportunities to do things in common, joining forces and potentially exploiting economies of scale and scope. This is where some form of consolidation is required.

Combining these 2 lines of action is tricky, as they are not necessarily mutually supportive: on the one hand, raising tariffs can relax the pressure to generate efficiency gains – in addition to inflating affordability issues; on the other hand, keeping tariffs too low deprives service providers from the resources they need to achieve efficiency gains. The national strategy sketched here explores the preferred option to combine these two lines of action. Consolidation is key, but it is not the silver bullet and needs to be accompanied by a range of measures.

It would be inappropriate to delay efforts to enhance efficiency in planning future investments and delivery of services until more problems occur. The time lag between deferred decisions (non-action today) and more serious decay of infrastructures and services quality is the time when reform should take place. It provides some room for manoeuvre to design and implement a strategically planned and consulted approach.

7.3. Preferred scenario for the aggregation of water utilities in Estonia

Discussions on consolidation of water utilities in Estonia have been dragging on for years, if not decades.

So far, discussions essentially considered one model of agglomeration, on a geographical basis, where well-functioning companies gradually absorb smaller, fragile ones. This model faces push back on two grounds:

- Well-functioning utilities (or the municipalities where they operate) are reluctant to merge, as absorbing less efficient entities would result in tariff increases, affecting their customer base (or dwellers)
- Smaller entities resist merging as they fear their voice will not be heard in the larger entity, and funding and investments will be redirected towards other, initially larger municipalities or utilities. Note that the recent administrative reform has diminished the number of –small - local authorities, making this concern less prominent.

This can explain that over the last 2 decades, experience with aggregation has remained minimal. This further suggests that aggregation will not materialise at scale or in time, should it only result from voluntary arrangements across local authorities.

The government then faces a dilemma: either keep aggregation voluntary, with limited ambitions; or consider an alternative model for aggregation. The first option will not deliver the efficiency gains required to put the sector on a (financially) sustainable path. This national strategy supports an alternative model for aggregation.

The point is not to move away from aggregation, but to provide some flexibility in aggregation patterns. For instance, not all functions may need to be operated at the same scale:

- Water supply could be operated at a different scale than sanitation
- Urban sanitation could be treated at a different scale (municipal) than rural (where a public entity could be created to monitor and service the operation of septic tanks)
- Sludge management could be operated at yet another scale (regional, building on larger agglomerations)
- Investment planning and procurement could be managed at a different scale than consumer relations and billing
- Some competences could be made available in regional centres, to support smaller utilities
- Specific trajectories could be considered for rural areas, which differ from urban ones. For instance, localised wastewater management systems could serve individual or small groups of properties. They would be coordinated through a public service, able to cover a wide and diverse territory, focusing on localised sanitation only.

The national strategy does not ambition to set a priori – from the top – what the appropriate scale is for each function. It is designed to set up the policy and regulatory framework and incentives to urge municipalities and service providers to explore different scenarios and aggregate as it makes most sense in their particular context. Decisions would still be made by local authorities and utilities, on the basis of multiple criteria, including:

- Opportunities to minimise cost (investment needs in infrastructure; operation and maintenance costs) and enhance financial sustainability of WSS

- Opportunities to mutualise skills (technical skills to operate and maintain assets; commercial skills to interact with users, including through billing)
- Opportunities to optimise performance (quality of service to users), now and in the future (sustainable service provision)
- Opportunities to strengthen monitoring and supervision (assessing development plans and expenditure programmes; monitoring performance of service providers).

A range of actions need to be taken in parallel, such as the adjustment of the tariff setting methodology, setting up capacities to review and assess the opportunity of investments and expenditure programmes (going beyond the assessment of eligible costs), organising benchmarking capacities to set performance objectives and review performance of water companies. Some of these actions relate to strengthening economic regulation. The action plan sequences these measures to ensure a smooth and effective transition towards the agreed-upon vision for a sustainable water industry in Estonia.

7.4. Incentives to foster consolidation of utilities

Considering the state of the water sector in Estonia, incentives have to do with easy or accelerated access to finance. The Estonian Environmental Investment Centre provides access to public finance. The amount of finance available for the water sector in the Centre could be gradually increased, to reflect the state of the sector and its importance for sustainable development in Estonia¹. With this notable exception, and in a context where EU and public funding will not be available, the primary source of finance now and in the future is expected to be revenues from tariffs.

Other sources of finance can be considered, such as commercial loans or private investments, but they would need to be paid back by a combination of EU funding, public finance or revenues from tariffs. This point confirms that private finance will only be accessible in practice when a number of requisites are met, including robust management of utilities and a stable revenue flow through tariffs.

The proposed option to enhance revenues from tariffs is to offer accelerated depreciation of assets under certain conditions. In essence, the proposed line of action is to keep the tariff setting principles as they are, and to add an option for accelerated depreciation of assets under conditions to be agreed upon by the economic regulator and the Ministry of Environment.

One additional incentive is recommended: to reward utilities that explore ambitious options to enhance the efficacy of development plans. Those utilities that submit more ambitious plans from that perspective could be offered preferred treatment for investment projects, more advantageous conditions to raise tariff, access public finance (possibly through the Estonian Environmental Investment Centre), or smooth economic regulation such less cumbersome authorisation programmes or other administrative measures that can facilitate the operation of water companies.

As it is not practical to define and measure the ambitions of development plans in an abstract way, this could be done through a benchmarking process that would go beyond the comparison of costs and include the comparison of levels of performance and of development plans. Such an extension of performance benchmarking for water supply and sanitation in Estonia would require collaboration between the economic regulator (tasked with the review of development plans) and the Ministry of environment (which sets the level of ambition required for the sector) and local authorities (formally accountable for development plans).

The proposed incentives would deliver most effectively if backed by some pressures or threats. Two kinds of pressures have been evoked in the course of the project:

- Set a timeline to achieve a set level of collective performance². Should that level not be achieved on time, the government would take mandatory action to aggregate utilities according to its preferred pattern. This would strip municipalities from their capacity to decide on the organisation

of water services; it would deprive utilities from exploring options that may be more advantageous to them. The risk is that the pattern imposed from the top may not be optimal.

- Revoke licences for utilities that are unable to achieve a certain level of performance or that do not demonstrate the appropriate level of ambition to enhance efficiency. This line of action assumes that water utilities are licenced first. Indeed, licencing requirements for water undertakings may be a feasible measure to ensure technological, financial and managerial capacities of water undertakings. Depending on the licencing conditions, such requirements may encourage consolidation within the WSS sector, where service providers with incompetent organisation and weak economy are gradually directed to merge or otherwise consolidate their business with regional and/or otherwise sustainable water undertakings. A decision is required on who manages services, which licences have been revoked. In Lithuania, where licences are already in place, a guaranteed operator (the largest in the region) has been defined by default and would be mandated to step in.

7.5. Technical – including legal - issues to be tackled

Implementation of the strategy sketched above requires that a range of legal and regulatory issues are tackled. They are listed below.

7.5.1. *The legal forms and patterns of inter-municipal co-operation*

An Estonian commercial association is to be preferred as the legal form of consolidation vehicle. This provides a status and the needed flexibility to support gradual functional integration - and aggregation, should it occur.

Any municipality or water company may become a member of a commercial association created for the purpose of facilitating co-operation in the WSS sector.

In the general meeting of commercial association, each member has one vote. International experience provides an example of how local control over tariff decisions can be retained, while a broad spectrum of WSS activities could be effectively contracted out through a partnership arrangement to secure benefits associated with available economies of scale. Forms of consolidation within this broad approach can differ in a range of ways, including in terms of the scope and depth of service provision activities that are covered: e.g. joint provision of various operational activities vs the pooling of investment planning, the awarding of works contracts, and of financial capacities.³

As a way of consolidation, the municipalities and/or the water companies may share functions, or outsource a part of or whole provision of WSS services to a regional service provider. To facilitate the outsourcing, two main alternatives of asset regime shall be considered: (i) ownership of WSS assets remain with the municipality/water company commissioning the services, or (ii) ownership of WSS assets are transferred to the service provider.

Upon withdrawal from such association, the return of the assets to the original holder (leaving member) may be carried through as prescribed in the articles of association or in the members' agreement.

7.5.2. *Support from the Ministry of Environment*

While it is not primarily legal in nature, support from the Ministry to local authorities may include the following accompanying measures:

- Strengthen the role of county associations or cooperation between municipalities, to support the creation of larger (regional) utilities, if and when appropriate

- Support to contractual arrangements between such associations (where in place) or municipalities and the larger utilities. In 2006, the Ministry of Environment drafted models of agreements for water companies; they can provide a basis on which to build, although they need to be updated. Performance-based management contracts could be promoted
- Water Operators Partnerships (WOP) consisting of reputable operators. Partnerships with experienced operators are critical to develop and strengthen the newly formed organisations. Adequate incentives can encourage consolidated utilities to support localities that are not yet part of the association.

7.6. Tariff policy and methodology

This section covers both the tariff setting methodology and the tariff setting process.

7.6.1. The tariff setting methodology

In broad terms, the tariff policy and tariff setting methodology are adapted to the Estonian context. However, that can be refined and improved in several ways.

An important feature of the tariff setting process is the depreciation method. The existing CA approach is likely to provide an appropriate basis upon which to determine the allowances provided for depreciation/capital maintenance within the tariff formula. It can provide a pragmatic and flexible way of allowing financial sustainability issues to be addressed where they have been shown to be material, while also guarding against the risk of customers facing unduly high charges.

This approach would benefit from further formalisation and articulation – for example, through publishing guidance – so that there is greater clarity over the scope for utilities to seek accelerated depreciation provisions. Those conditions could be developed in ways that take explicit account of the risk that providing more funding through charges may tend to dampen the efficiency incentives that might otherwise apply. The CA could underpin this approach by identifying relevant cost and service performance criteria that it would expect companies to satisfy in order to qualify for potential access to accelerated depreciation provisions.

The approach could also be linked directly to the extent to which different forms of consolidation plans were being pursued, with greater scope for the acceleration of depreciation provided to utilities that develop such plans in a robust and credible manner (see the following section, on benchmarking).

7.6.2. The tariff setting process

The tariff setting process and formula could provide for prices to be adjusted automatically in between tariff reviews by reference to movements in defined indices. In particular, it may be desirable for some input price risks (including potentially those associated with movements in energy prices, but also, although more complicated, labour or construction costs) to be managed through the use of some form of indexation, such that prices can better reflect prevailing conditions without the need for further regulatory review.

The tariff setting process could benefit from some alignment with international good practices. At the moment, tariffs are reviewed at the demand of utilities, leaving scope for strategic behaviour by utilities to only request a review when they expect to benefit from it. The CA may wish to introduce a periodic approach to price reviews (for instance, every 3 years), and develop principles which limit the extent to which existing price controls would be 're-opened' as a result of consolidation activity. This provides scope for companies to benefit from savings they are able to make in the period between re-determinations. At the same time (or while managing the transition towards periodic price reviews, the CA could review companies – to some extent at least – in clusters. This would ease comparison of data and state of play.

Of note: in cases of aggregation, while it makes sense to converge towards a uniform tariff within the new entity, the convergence process can be phased over several years, to minimise impact on consumers, and let time of the benefits of aggregation to materialise, thereby minimising the need to increase tariff at all.

7.7. Independent economic regulation for WSS

In addition to tariff setting, economic regulation plays a critical part in the aggregation policy. This section covers other functions to be taken on board by the Competition authority in Estonia. The focus is on the organisation of a benchmarking process, which builds upon - but significantly expands - the existing practice and traffic light system.

7.7.1. Develop a Service Performance Incentive framework

In Estonia, economic regulation is based on costs. This can be an issue, as one way in which a company may be able to out-perform a price control settlement is to deliver less. This could manifest itself is through cost savings being made in ways that tend to undermine some aspects of service quality. Therefore, cost-based regulation needs to be supplemented by robust monitoring of service provision and quality.

In Estonia, it is not clear which institution – if any - assesses whether expenditure programmes are opportune and identifies eligible costs (eventually reflected in tariffs). Currently, the CA considers local development plans – often drafted by utilities and endorsed by municipalities - as reference documents. This leaves no room to assess the potential benefits of considering development plans at an aggregate level, thereby generating economies of scale or scope.

In that context and considering the case for reform made above, it would be most appropriate if the CA develops incentives that focus on company plans, and planning processes. In the absence of such development plan incentives, companies may be unduly conservative in their planning, and do too little to address the major efficiency and financial challenges they face. In practice, this kind of development plan quality incentive approach can comprises of three core features:

1. Identify categories of development plan quality
2. Identify criteria to determine which quality category a development plan should be identified as in
3. Identify how companies will be treated differently, depending on the category they fit in. For instance:
 - a. The explicit provision of some other form of financial reward: for example, access to grant funding or preferential borrowing opportunities
 - b. Greater scope for support with respect to financial sustainability, using accelerated depreciation (taking account of bill affordability and acceptability issues)
 - c. Scope for the price control to be determined for a longer period
 - d. Presentation of the outcomes of the assessment in a way that can be expected to provide material reputational benefits for those associated with successful companies
 - e. Procedural benefits associated with less extensive review requirements, providing overall performance remains sufficiently 'on-track'.

7.7.2. Harness transparency as a policy tool

The approaches that are adopted to providing for transparency of performance information – and, more broadly, for stakeholder engagement – provide an important part of the way that regulators seek to encourage performance improvements and guard against the deterioration of performance.

The current information that is provided can be viewed as a useful first step, but much more could be done to seek to improve and refine the set of KPIs that are presented, to develop ways of providing more

meaningful benchmarking of performance between companies (including through comparisons within and between different clusters of companies that may share broadly similar operating conditions, at least in some important respects), and to communicate that information in more prominent and easier to understand ways.

It is important to note that the information under discussion here concerns different aspects of the performance of monopoly public service providers. While there is likely to be some relevant performance information that it is appropriate to treat as confidential (for example, for security reasons), experience from other countries clearly shows that substantial levels of performance information can be made available while at the same time taking appropriate account of relevant confidentiality concerns.

Moving beyond sharing information on individual and relative performance of service providers, awareness raising via information sharing and nudging can go a long way in making the case for change. It can take the form of strategic planning for the sector (a role for the Ministry of Environment) or reporting on practical consolidation experience (this could be arranged by the association of water utilities).

7.7.3. A role for the Ministry of Environment

A National Water Strategy, backed by a thorough and realistic financing strategy, could be envisaged, to set the overall level of ambition and provide a reference to draft development plans and assess the opportunity of projected investment, and possibly encourage local governments to join forces. The objective of the proposed strategy would be, for each municipality, to:

- Identify long-term needs (based on population and economic development forecast) and source of water supply; impacts of climate change (and risks of flooding or scarcity) could be factored in, as appropriate
- Identify investment needs for rehabilitation, replacement or extension of the water and sewerage facilities (including granted assets, which will need to be renewed even though they were financed without domestic finance) and their costs
- Explore options for mutual investment and joint action with neighbouring communities. The proposed options could be prioritised when they align with the national water strategy and financial strategy.

Table 7.1. Wrapping up

| ISSUES | PREFERRED OPTIONS |
|---|---|
| Overarching strategy | functional aggregation voluntary, performance-bound |
| Technical – including legal – issues to be tackled | governance arrangements conditions required for joining and withdrawing from associations regime of assets tariffs of the aggregated company (separate but converging) |
| Incentives to foster consolidation of water companies | financial incentive (accelerated depreciation, preferred access to public and EU funding) preferred treatment (e.g. authorisation programmes, licencing) |
| Tariff policy and methodology | accelerated depreciation |
| Independent economic regulation for water companies | benchmarking costs + performance + development plans rewards/sanctions for performance achievements a national plan |

7.8. A tentative action plan to transition towards aggregated water services in Estonia

Table 7.2. A tentative action plan to transition towards aggregated water services in Estonia

| Objective | Action | Champion / Partner(s) | Deadline |
|--|---|--|--------------------|
| Set levels of expectations. Provide a reference for service quality, operators' performance, and ambition of development plans | Develop a national strategy for WSS ¹ , supported by a financing strategy. The national strategy would set performance objectives for utilities (to be considered when setting licensing criteria, performance benchmarking) and / or targets for aggregation | MoE (in consultation with all stakeholders) | Short |
| Consider setting up licenses for water and sanitation utilities | Engage a consultation with the association of water utilities to set up licenses for WSS services. Criteria would be defined by the CA, in line with the overall ambition set by the MoE | The MoE initiates the discussion. The CA defines the criteria, in line with the MoE's priorities and in consultation with the association of water utilities | Short |
| Provide guidance for the governance of aggregated entities | Strengthen the role of county associations and regional entities Support contractual arrangements | MoE (in consultation with municipalities and association of utilities) | Medium |
| Enhance potential financial incentives | Increase public funding available for WSS in the Estonian Environmental Investment Center | MoE (as field ministry) in consultation with MoFinance | Medium |
| Provide incentives through tariff methodology and process | Clarify criteria to be granted accelerated depreciation, and modalities Define the modalities of periodic reviews and of clustered reviews Include indices in the tariff formula (e.g. on energy, labour, construction costs) | CA (in association with association of utilities) | Short |
| Provide guidance for performance benchmarking (including development plan benchmarking) | KPIs and a process to interest utilities Set up development plan benchmarking (define number of categories; criteria to assess development plans; special treatment for most ambitious plans) | CA (in coordination with MoE and association of utilities) MoE engages with local authorities | Short Medium |
| Address affordability issues (in particular in small communities) | Consider other instruments to finance environmental policies that benefit the larger population (beyond water users) | MoE (in consultation with MoFinance and the association of local authorities) | Long |
| Raising awareness. Nudging | Engage with local authorities to make the case for change Report on successful functional coordination | MoE (in consultation with association of local authorities) Association of municipalities and Association of utilities | Short Short |

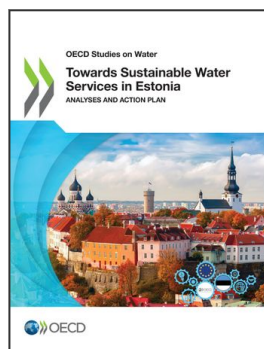
1. Chapter 5 suggests that, while a reference to a national strategy could feature in the legal framework, the strategy itself could be considered a secondary piece legislation.

Notes

¹ In principle, this could be done in two ways: 1) budget allocation to the Centre are revised in the context of the budgetary process; 2) economic policy instruments that generate (earmarked) revenues to the Centre could be increased. The second is preferable as it is less dependent of the vagaries of budgetary decision making.

² During stakeholder consultation, 5 years was suggested as a reasonable – though ambitious – timeline, considering that discussions on consolidation has been going on for decades in Estonia.

³ See, for example: https://www.slideshare.net/OECD_ENV/joint-workshop-on-enhancing-efficiency-and-sustainability-of-water-supply-and-sanitation-presentation-joseph-hermal-249807561



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