

4 Report with recommendations on financial and governance incentives

Financial and governance incentives matter to accelerate the consolidation of water services in Lithuania. The chapter explores options to address the specific concerns of small municipalities and well-managed utilities, who believe they might be worse off after consolidation. Practical options inspired from international good practices confirm this does not need to be the case.

4.1. Introduction

Chapter 4 highlights why financial and governance incentives matter to accelerate the consolidation of water services in Lithuania. Experience over the last few years suggests that reorganisation of water services in Lithuania raises issues that relate to the governance of water utilities. Two sets of issues have emerged. The first one is political. On the one hand, small municipalities are reluctant to merge utilities with larger ones as they fear their voices would not be heard in the larger context. The Chapter claims this can be addressed by flexible governance arrangements, which acknowledge the rights of all municipalities. On the other hand, well managed (usually larger) utilities are reluctant to consolidate with smaller ones, as they project that they would need to raise tariffs to compensate the lack of efficiency and the investment needs of less performing ones. The Chapter argues that this concern can be addressed through tariff policy.

A second set of issues relate to more technical considerations, such as the ownership of assets in a merged entity, or the possibility of withdrawing from consolidated entities. The Chapter shares some models in place in European countries, which can help address these issues.

As explained in Chapter 3, progress towards some form of consolidation requires that types of arrangement are clarified between a regional utility and local authorities, to either operate assets owned by local utilities (which will not directly operate these assets anymore) or transfer asset ownership to the regional utility. Progress also requires that governance structures are available, which ensure that local authorities keep some control over decisions related to the asset on which service delivery depends.

The Chapter should be read in combination with others. In particular, Chapter 7 explores financial incentives in the context of the tariff setting process, in particular through accelerated depreciation of granted assets under certain conditions, which could include development plans that seriously consider options for efficiency gains through consolidation of assets and services.

Of note: the issues mentioned above essentially emerge in the context of merger of utilities. More flexible consolidation arrangements discussed in other Chapters, in particular in Chapter 6 on scenarios for two pilot regions, make these considerations less pressing, or offer more time to address them.

4.2. The governance of utilities. Practical options to facilitate consolidation

As mentioned above, two sets of governance issues need to be addressed to overcome practical resistance to consider consolidation of water utilities in Lithuania. The first one relates to the organisation of the governance structure, to reflect the interest of the different constituencies; it relates to power and political considerations. The second one – more technical in nature – refers to the status of assets and other managerial issues. A third type of incentive is discussed in this section, as it is being considered by the Ministry: the revocation of licences to operate water and sanitation services.

As illustrated in Chapter 5, “lighter” organizational arrangements would address potential concerns related to the governance of consolidated entities, as they allow for the consolidation of the sector while maintaining existing water companies, although with different levels of responsibility and independence. These arrangements include: (i) cooperation agreements between providers with a well-defined scope; and (ii) delegated contracts signed between the jurisdiction level in charge of service delivery and an operator, transferring all or most of operational responsibilities. See Chapter 5 for a more detailed discussion.

4.2.1. Organising power relations in consolidated entities

The concern expressed by smaller entities that their capacity to make decisions and reflect the interest of the customers would be diluted in cases of consolidation is valid. It needs to be considered and addressed. The international workshop on lessons learned from European experience with consolidation of water utilities provides a range of options, which can be adjusted in the Lithuanian context. They reflect a range of decision-making arrangements and voting rights allocation. In most cases, the power sharing arrangement is done in such a way that it does not provide exclusive power to the largest city as a single shareholder, to ensure a balance of power and create incentives for consensus-building (see the Table below).

Table 4.1. Comparative advantages of alternative methods for allocating voting rights

Method for allocating voting rights	Potential advantages	Potential drawbacks	Examples
According to the number of customers, the number of connections, or the value of the assets	Sound economic basis	Varies from year to year	Águas do Ribatejo (Portugal)
One entity = one seat	Simplest rule	Can be unacceptable for larger entities	SDEA and SEDIF (France)
Specific powers for the dominating entity, if there is one	Necessary to gain confidence of the larger entity	Small entities have limited influence	This rule was used to a certain extent in Raja Constanta utility (Romania)
Mixture of the two solutions above	More democratic rule, with a minimal representation for small communities	May deter the more powerful municipalities from joining	Nîmes Metropole (France)

Source: The World Bank (2005)

One institutional arrangement deserves particular attention, as it illustrates how flexibility can guarantee access to decisions (see also Chapter 5, where this case is presented as well). In France, *Syndicat des Eaux et de l'Assainissement Alsace-Moselle* (SDEA) is an aggregation of water utilities, triggered by a national regulation. The NOTRe Act mandated the progressive transfer of water and sanitation services competence from municipalities to integrated intercommunalities, with the purpose to achieve economic efficiency (through economies of scale), and solidarity (through economies of scope).

The SDEA is a public establishment of cooperation specialized in the water field and federates different municipalities/group of municipalities/Strasbourg EuroMetropol and the Bas-Rhin department. The idea from this federation is to have one establishment that manages drinking water production, river streams, reservoirs, and wastewater collection and treatment for all members of the federation. It comprises 737 municipalities and is administrated by local elected officials from different municipalities. The SDEA comprise three levels of governance, and namely:

- Global scale: bodies at the local scale include a General Assembly, a Board of Directors, a Permanent Commission, Thematic Commissions and Tender Commissions. This level is in charge of overall policy and economies of scale, adaptation of the common tool to the challenges, grouped purchases and pooling of financing capacities;
- Territorial scale: bodies at the territorial scale include Territorial councils and Contracts Commissions. This level is in charge of synergies, common projects, consultations across territories, pooling of local investments and sharing of best practices;
- Local scale: this level is administered by Local Commissions. It is in charge of proximity management, analytical financial management, definition of tariffs and financing, investment programs, awarding of work contracts and follow-up of local affairs.

The role of each constituency is adjusted at each level, according to different criteria, to ensure each municipality (and their dwellers) has some capacity to participate in decisions that affect it. Also, each municipality can opt for various levels of consolidation, starting by sharing information, and some functions, towards more coordinated planning and integrated management. This flexible arrangement provides for progressive consolidation, leaving time to build trust in to the consolidated entity.

Such a flexible and dynamic model could be considered in Lithuania, to address the inherently political resistance of small municipalities towards consolidation.

4.2.2. Managerial issues in consolidated utilities¹

Entry and exit clauses

Entry and exit rules set out the technical and financial conditions under which a service can join or withdraw from the consolidated entity. These conditions commonly include an asset inventory as most exit clauses foresee the repayment of depreciation costs when investments have been made. In addition, these rules also include governance arrangements that apply to newcomers.

Entry by new members can reinforce economies of scale and increase the demand and revenue base for the consolidated utility. Before allowing a new member to enter the aggregation, it is recommended to conduct a thorough analysis of the impact of such incorporation on the existing consolidated utility and to ensure that the following conditions hold:

- the new member accepts the general conditions of the grouping without too many changes
- the inclusion of the new member does not significantly change the aggregated structure's financial viability.

Once the new entry is accepted, the financial impact of this incorporation should be carefully evaluated to determine the value of the assets that may be brought in by the new entity, any potential financial compensation for such assets upon entry, and the number of shares or voting rights to be allocated to the new member.

Most aggregated structures make it difficult or costly for an existing member to leave. This is to discourage such exit because it can have a serious impact on the consolidated entity. For these reasons, the articles of association of the aggregated structure should include a section about exit rules which should establish rather severe conditions, such as:

- a minimum time between the time when the request to leave the grouping is formulated and the implementation of this separation (at least one year).
- the leaving entity should support transaction costs, as well as the costs of replacing shared facilities and infrastructure.

The articles of association may prescribe that:

- upon termination of membership the contribution is not refunded (although the member shall be paid the share of the assets it would receive if the association were dissolved)
- a member of an association shall pay reasonable compensation to the association upon leaving the association if exit causes significant damage to the association.

Upon withdrawal from the association, return of the assets to the original holder should be carried through as prescribed in the articles of association or in the members' agreement. A solution upon withdrawal from the association may be as follows:

- the member may (re)acquire any WSS assets it has transferred to the association and/or any assets created by the association that are located in the territory of the member municipality (or in the previous service area of a water undertaking);
- as a general rule, the leaving member may (re)acquire such assets free of charge (except as set out below);
- if the association has outstanding loan obligations connected to the creation of such assets, the leaving member shall compensate the association any such outstanding amounts;
- if such WSS asset is used to provide services to several members, the leaving member shall compensate the association the potential loss or damage resulting from such asset being removed from the possession of the association;
- any other reasonable technical or financial conditions upon (re)acquiring the assets (e.g. if the assets are created using financial aid, the conditions of the financier must be met).

4.2.3. Asset ownership, transfer, and management

Aggregation case studies exhibit a diversity of situations with regard to asset ownership, transfer and management. In most cases, asset remains under the ownership of local jurisdictions while its operation is handed over to an intermunicipal structure or directly to the aggregated utility through some form of concession contract. Inventories are then carried out to value the infrastructure and establish a depreciation schedule for future years.

When local jurisdictions transfer their WSS asset to the aggregated utility, this transfer can happen either for free, or according to one of the three following compensation methods; each of them bearing potential advantages and drawbacks (see Table below):

- through the granting of shares in the new entity
- through direct reimbursement by other members
- or through the payment of a lease fee.

Table 4.2. Potential advantages and drawbacks of alternative compensation solutions

Compensation solution	Potential advantages	Potential drawbacks
Shares in the new entity	Nobody has anything to pay	The entity bringing more assets has more voting rights, even if it is small
Direct reimbursement	All debts are cleared at the agreement signature	This solution could absorb most of the cash available for some entities, limiting their capacity to invest in new facilities development
Lease fee	A good formula for assets that cannot be sold (for example, water rights)	Potential difficulties arise if the leaseholder wants to leave

Source: The World Bank (2005)

Liabilities

Service providers that are aggregating may hold liabilities with regard to staff, suppliers and financiers, or claims on customers. These liabilities can represent significant transaction costs for aggregating utilities. As such, they have to be covered, either during the aggregation by the aggregated utility or separately from the aggregation by the local government budget. In most cases, the second option is favoured.

Harmonization of processes and practices

During the aggregation process, employment issues can be very sensitive. It is therefore important to consider issues of staff transfer very carefully. The transfer of the entire staff from the individual entities to the new aggregated structure is often not necessary, nor even desirable. Therefore, in most of cases, the consolidation process includes transferring some key staff to the new entity, often on a voluntary basis.

Transfer of staff from municipal structures into the aggregated utility must be planned and documented in quantitative and financial terms, including possible pension liabilities.

As labour cost is generally among the top budget items for a utility and the one where most optimization potential exists through consolidation, it is crucial to allow for the economies of scale to materialise. Indeed, staff transfer from former municipal structures into the newly aggregated utility generally creates heavy transaction costs, which translate into labour cost increases and can hamper the financial sustainability of aggregated entities.

Similarly, the harmonization of IT systems and administrative practices can generate transaction costs that can limit or delay the materialization of aggregation benefits. As such, they should be carefully dealt with. The aggregation agreement should include clear costing and strategy with regard to IT systems harmonization and integration, and database management.

When the scope of aggregation includes consolidation of functions, harmonization of administrative practices across consolidating utilities is necessary. This harmonisation strategy - which encompasses tasks such as procurement, accounting, quality control - has to be set up ahead of the aggregation implementation. In the best-case scenario, this harmonization leads to levelling standards up to those of best practices. However, under less favourable circumstances, harmonisation may lead to levelling costs up, thus hampering the success of aggregation.

4.2.4. The role of and process for licence revocation

The fact that Ministry is making the threat of licence revocation in the future does have quite a big effect on the context within which any arrangements would be applied, such as those discussed in Chapters 7 (on water tariffs) and 8 (on the performance of water utilities).

The Ministry of Environment's planned WSS sector reforms include the development of new criteria – including service quality requirements - for licensed activities, operating a mechanism that applies when a licence is revoked, and strengthening the role of the regulator. This section considers the Ministry's proposal with respect to licence revocation. It also sets out why there looks to be a strong case for the Ministry to adopt an ongoing coordination and tracking role with respect to the achievement of environmental policy objectives and obligations.

In regulated sectors, licence revocation would typically be viewed as a fairly extreme intervention, and one that reflected the conclusion that other available options within the licensing framework were unlikely to provide a sufficient response. Those options can potentially be quite varied and will in some jurisdictions include scope for significant financial penalties to be applied where a company can be shown to have been operating in breach of its licence obligations.

That said, the explicit consideration of licence revocation in the Ministry of Environment's planned reforms looks to be well-judged, and to reflect an important and legitimate concern over how the WSS sector in Lithuania might evolve. That is, Ministry is clearly identifying the 'opening' position as not a sustainable one, such that it expects material changes to the structure and operation of the sector to be necessary feature of addressing adequately the challenges that are faced. The Ministry is looking to facilitate the transition of the sector through the enhancements to the framework that it is developing, but the risk remains that some companies may not respond in ways that provide for a level of progress that is viewed

sufficient. Licence revocation is being explicitly pointed to as a potential ‘backstop’ measure, which could be used if such circumstances arise.

The scope for licence revocation to occur can be understood as having important incentive properties. In an obvious sense, the force of the licence – and the conditions it provides for – can be viewed as closely related to the scope for revocation, with this providing the ultimate sanction in the face of non-compliance. Also, however, the possibility of revocation can affect the likely significance of ratchet effects of the kind discussed in Chapter 7. In particular, while ratchet effects can tend to dampen incentives to bring forward efficiency improvements (because they may be used by the regulator to impose a tougher control going forward), scope for licence revocation can be understood as putting companies on notice that sufficient efficiency improvements will need to be implemented within an overall period – say 10 years. It can therefore provide a desirable source of counter-pressure, in a context where there may otherwise be significant inertia and/or incentives to defer the kind of actions that might be required to deliver improvements.

An important question arises, however, as to the extent to which the prospect of revocation is likely to be viewed as credible. That is: to what extent would companies and municipalities consider it likely that the process of licence revocation would actually materialise? A critical issue here typically concerns the extent to which a clear process has been identified in terms of how licence compliance risks are managed within the regulatory framework, and then the extent to which that process is actually used in practice. This is important, because the severity of licence revocation as a regulatory response is such that one would expect it to have been preceded by a range of other less severe actions that can be shown to have been insufficiently effective. Where that is not the case, there may be significant risks of a revocation decision being challenged (legally and/or more broadly) as being disproportionate, premature and/or as otherwise unfair.

Regulators often seek to manage these kinds of enforcement risks through developing and publishing (and then demonstrably applying) an enforcement policy, setting out how they will go about responding to identified risks concerning licence compliance. A critical feature of such a policy is typically setting out an approach to escalation: that is, setting out the steps of increasing severity that the regulator might expect to adopt where compliance risks have been identified. This escalation process can then provide a guide that the regulator can use when tackling a specific issue, or set of issues, and where its actions do not appear to be generating an appropriate regulatory response in terms of behavioural change and outcome improvement. Ofwat’s enforcement policy illustrates how its regulatory approach would be expected to move from one where largely informal, ad hoc communications may be viewed sufficient, through a process of more formal reviews and sanctions, before a special administration process would be invoked.

4.3. Financial incentives to facilitate consolidation of water utilities

Stakeholders met in the kick-off meeting, in consultation meetings and in regional meetings argue that financial incentives are required to make consolidation attractive. In the recent past, such incentives have been the main drivers for utilities to consider consolidation. However, opportunities for financial incentives have decreased drastically as a combination of two factors: the gradual phasing out of EU funding for investment in water supply and sanitation in Lithuania, and the scarce domestic public financial resources.

Still, several options exist that provide financial incentives for the consolidation of water supply and sanitation services in Lithuania. The first one consists in revoking a financial disincentive. The second one is embedded in proposed revision of the tariff policy: it consists in rewarding best-performing utilities, in particular the ones that consider some form of consolidation in their development plans.

4.3.1. Addressing issues related to the convergence of water tariffs after consolidation

As noted above, larger utilities are concerned that their customer base would be affected in cases of consolidation, if consolidation leads to an increase in water tariffs. While it is likely that consolidation leads to an increase in tariffs of best managed entities, this concern can be addressed in three ways.

First, it can be argued that the impact on water bills for the better managed (often larger) utility would be minor, as the customer base on that company is larger than the one of the smaller – less efficient – one. In Klaipėda – the region where a regional WSS operator was created – the tariff of services for urban residents slightly increased after the reorganisation, while for the district, the tariff decreased by almost 50%².

Second, it is likely that customers of the larger utility can afford a higher tariff, as they would usually be better off (assuming they live in urban settlements, with access to labour and other services).

Finally, and most importantly in terms of policy, consolidation does not necessarily require convergence of water tariffs. While convergence certainly makes sense, it can be managed over an extended period, smoothing the transition and avoiding political resistance. Actually, as mentioned in the comments on the draft water law (Chapter 5), convergence of water tariffs in cases of consolidation raises some potential problems in terms of consolidation, and would seem to merit careful attention. This is particularly so as Article 34(6) appears to limit the scope for price differences within a newly consolidated regional supply area to 3 years. Such a requirement could be viewed as generating a significant disincentive to consolidation for those customers whose initial prices are lower, and who would effectively be asked to pay more to cross-subsidise other customers. A more flexible approach could be considered, where the long-term objective of price convergence could be maintained without that translating into a necessary price increase for those customers in the low-cost area in the short-term.

4.3.2. Embedding incentives in the tariff policy

Tariff policy provides an opportunity to incentive performance through some form of consolidation. The instrument to be considered relates to the depreciation of assets, more specifically of granted assets (i.e. assets financed through EU funding). Chapter 7 explains how the policy options for asset depreciation contribute to several – at times conflicting – policy objectives or priorities: putting pressure on utilities towards efficiency, keeping tariffs low to address social issues, and generating financing capacities for future development and the maintenance of existing assets. The prevailing method in Lithuania favours the first two priorities above. Utilities have an interest in the third one, which would require an extension of the regulated asset base, meaning the allowance to depreciate granted assets.

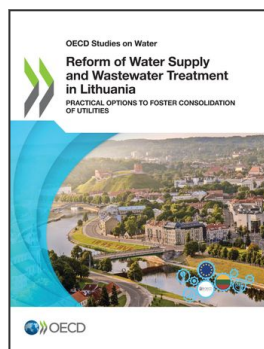
Chapter 7 argues that, while the prevailing method should be maintained in the Lithuanian context, it could be amended to allow accelerated depreciation under specific conditions. Accelerated depreciation benefits utilities as it triggers a raise in tariff, generating additional revenues from water bills to finance future expenditures. The conditions under which accelerated depreciation could be granted are to be set by the Ministry, in coordination with the regulator. They could include some form of consolidation. As discussed in more depth in Chapter 6 (on scenarios for two pilot regions), these forms are not limited to full merger. They could include the lighter arrangements mentioned above, such as sharing of functions. A most demanding coordination, such as coordinated development plans, would be particularly rewarded.

Similarly, as discussed in some depth in Chapter 8 (on benchmarking the performance of water utilities), the allowed return on equity could vary depending on the level of ambition shown in a company's price submission or development plan, where ambition here refers to the exploration of options to trigger efficiency gains through some form of consolidation, most appropriately, through coordinated development plans.

Notes

¹ This section builds on a review of European experience with consolidation of water utilities, by Maria Salvetti.

² Of note: in Lithuania, a water company is not allowed to differentiate the price based on the location of the consumer. However, it is possible to set different prices by customer segments. It remains to be seen how this principle is compatible with agglomeration in practice.



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