

4 Concept note on consolidation options

While the Estonian government is finalising a piece of legislation to set the direction for the future of water supply and sanitation services, the concept note conveys the main messages that derive from the on-going policy dialogue. The emphasis is on the broad options for consolidation (moving away from merger as the only way forward) and the incentives to support a voluntary process.

4.1. Background

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.

This chapter provides a concept note that considers potential options for the consolidation of WSS services in Estonia, and sets out a number of key features of a proposed overall approach. More detailed and technical issues concerning potential changes to the legal framework, and to tariff setting and the further use of performance incentives, are considered in Chapter 5.

The development of the approach set out below – which proposes that consolidation be viewed and promoted as a process that could take a range of different forms that can evolve over time – was informed in important respects by an international workshop, which featured a wide range of relevant international participation and experience. Among other things, this experience highlighted the extent to which there are a range of different ways in which benefits from coordination can be achieved, and that different forms of consolidation can coexist within a country in ways that can reflect marked differences in the nature of the challenges that are faced (given, for example, differences in the density of the population that WSS services are intended to serve in different areas). This is identified below as highly relevant to the development of an approach to consolidation, given in particular the range of different circumstances faced within Estonia, and the policy focus on achieving consolidation on a voluntary basis.

The first section makes the case for consolidation, with the scope it offers for enhancing potential gains, both in terms operational efficiency and efficiency in development and investment plans. It also explains why now is the right time to accelerate progress towards consolidation. The second section presents incentives for consolidation, which can support a bottom-up, voluntary process in Estonia. The section explores implications for practical policy approaches to consolidation in an Estonian context.

4.2. Conceptual framework for the reform of consolidation

This section begins by recapping on the case for WSS reform, highlighting in particular some of the different ways in which consolidation matters in terms of meeting the efficiency and associated affordability challenges that lie ahead. The distinction is then drawn between focusing on a specific model of consolidation based on geographical agglomeration – where well-functioning companies gradually absorb smaller, more fragile ones over time – and the adoption of a broader and more open perspective that could incorporate a range of different models and forms of consolidation that would include the geographical merging of companies, but could also include different forms of joint operation that do not require a merger, and may be linked to the shared provision of a set of specific functions. In principle, consolidation benefits could be achieved through either of these routes, and international experience shows that a range of different structures can be used.

This section ends by highlighting that when considering the trajectory that is likely to be best suited to – and most feasible in – the Estonian WSS sector, the commitment to consolidation on a voluntary basis is a key factor. In particular, this implies that careful attention should be given to the extent to which different trajectories can be expected to be compatible with the incentives that different companies and their municipality owners may face. The next section goes on to consider these incentive issues in more detail and to highlight the extent to which incentive effects might frustrate the effectiveness of a voluntary approach that is focused only on a regional agglomeration model. This confirms that a flexible approach that encompasses different modes of consolidation might a pragmatic and effective way forward.

4.2.1. The case for reform and scope for benefits from consolidation

As was noted in Chapter 2, there is a significant level of agreement among stakeholders that the current arrangements for WSS provision in Estonia are not sustainable. There has been substantial investment in WSS infrastructure in Estonia since its accession to the European Union, with this providing a wide range of benefits in terms of service quality and environmental protection. However, the delivery of these improvements has relied heavily on EU funding, which has accounted for around half of Estonia's WSS total expenditure - and around 85% of capital expenditure - in recent years.¹ The European Commission has indicated that financial support for the sector will be gradually phased out, and the Estonian Ministry of Finance has confirmed that domestic public finance will not provide a substitute source of funding. Given this, it will be necessary for a financially sustainable and socially acceptable financing model to be developed, based on prevailing – and expectations of future - WSS tariff revenues.

Substantial further investment will be required over time both to maintain (and where relevant replace) existing assets (including those assets that were funded using EU grants), and to enhance treatment processes where needed in order to meet current and future compliance obligations. This highlights the potential for significant tensions to arise over time related to the affordability and acceptability of associated WSS bill increases. Also, while the implications of the Covid pandemic on demographic changes remains unclear, pre-pandemic forecasts identified trends that would exacerbate the financial challenges to be faced, particularly in those areas of Estonia where a substantial population decline had been forecast.

The likely scale and nature of future investment requirements raises major concerns over the financial and technical capacity of the WSS sector – in its current form – to develop and deliver appropriate programmes of work in efficient ways. These concerns have underpinned the emphasis that has been put on the benefits that could be achieved through greater consolidation within the sector. The economic characteristics of the sector (in particular, the scope for achieving economies of scale and density in the undertaking of relevant activities), and the fact that the WSS sector in Estonia is still highly fragmented (in 2018, there were 177 water companies operating in Estonia), strongly suggests that there may be scope to deliver substantial benefits through consolidation. This can be important for both:

- The efficient delivery of services and planned investments; and,
- The efficient identification and planning of future service and investment requirements.

The efficient delivery of services and planned investments

There are a range of ways in which consolidation may provide opportunities to improve the efficiency with which services and planned investments are delivered, including potentially through:

- More efficient labour resourcing for, and scheduling and financing of, planned work such as enhancement projects (for example, the provision of new treatment technologies), asset refurbishments/replacements, and routine monitoring, repair and maintenance activities. Consolidation may allow for the smoothing over time of (through the use of a more coordinated approach across areas), and enhanced technical capabilities in relation to, what might otherwise be 'lumpier' requirements that are more difficult to finance and manage.
- More efficient approaches to managing unplanned/reactive work, such as may be required to address pipe bursts, sewer collapses, and other relevant incidents. The efficiency of these types of activities can have a significant bearing on a number of dimensions of performance, such as leakage, for example, by improving response times and capabilities.
- More efficient procurement of, and management of the cost risks associated with, inputs such as energy and chemicals.
- More efficient provision of customer-facing, administrative and support activities, where scale can offer considerable opportunities for both cost savings (e.g. through reduced duplication) and

quality improvements (e.g. through the introduction of improved information provision processes).

The efficient identification and planning of future service and investment requirements

The above can be understood as largely taking service provision requirements and investment plans as given, and focuses attention on some potential ways in which the efficiency of delivering those requirements might be enhanced through consolidation. However, the likely scale and nature of the future WSS investment requirements in Estonia makes it critical also to consider efficiency in relation to the identification and planning of future requirements. Importantly, there are likely to be different ways in which policy objectives associated with environmental requirements and service quality/access targets could potentially be tackled, and the decisions over which approaches are selected can be expected to have long-term implications for the cost, quality, and/or environmental consequences of service provision.

Determining the appropriate approach to the development and use of tertiary treatment processes – such as those used to reduce phosphorus concentrations in wastewater discharges – may be particularly challenging. Tertiary treatment can be very costly to introduce, and the ‘cost per population equivalent’ of introducing such processes can increase steeply as the scale of treatment plant falls and the stringency of discharge consent requirements is tightened.² Given this, decisions related to the introduction of such processes can have a particularly marked bearing on costs in areas which are less densely populated. Also, the adoption of a given approach may have the effect of ‘locking-in’ a service provision model – and the funding implications associated with it – for many years, including, for example, because of the ongoing chemicals procurement costs that will be associated with some treatment approaches.

Consolidation (of one form or another) may provide opportunities for significant efficiency benefits in relation to the identification and planning of appropriate responses to environmental requirements, including because:

- There may be significant benefits associated with the assessment of options in more coordinated ways across broader geographic areas.
- The effectiveness of the options identification and appraisal process may be heavily dependent on the availability of appropriate technical expertise, and this can be much more difficult to provide for at smaller scale (that is, there can be significant economies of scale in the provision of relevant technical expertise).

These factors could have a substantial bearing on the efficiency of the approaches adopted in multiple ways. For example, beneficial opportunities to increase scale may be identified, in a context where (as was noted above) unit costs can fall steeply as plant size increases (such that tertiary treatment may be introduced at one larger plant, rather than separately at two or more other plants, following appropriate network development). Alternative treatment approaches – such as those which use ‘natural capital’ solutions – may be identified as preferred given estimates of ‘whole-life’ costs and other sustainability considerations. In principle, there may be opportunities to explore whether the introduction of costly ‘end-of-pipe’ treatment options can be avoided (particularly at smaller sites) by delivering equivalent environmental outcomes in other ways. We note that it is common, in a range of jurisdiction, for WSS companies to seek to contract with farmers in order to get them to adopt practices which result in reduced concentrations of potentially harmful substances in water courses.³ This kind of catchment management approach can, in some circumstances, provide substantially less costly way of improving environmental outcomes than the introduction of complex tertiary treatment processes.⁴ We understand that, in relation to existing HELCOM requirements, there would not be scope to adopt this type of approach, and indeed that the types of tertiary treatment that have had to be introduced in order to meet those existing have not thus far given rise to disproportionate cost implications for smaller treatment facilities. We note, though, that the exploration of (and the flexibility to pursue) alternative approaches is likely to merit careful attention in the event that the introduction of more stringent tertiary treatment requirements that could apply to smaller facilities comes under consideration.

There may also be significant benefits from adopting a broader (more consolidated) geographic perspective when other policy objectives are being considered. For example, the costs of increasing access to public WSS systems can be expected to differ markedly between areas, including - importantly - because of population density considerations. This may also point to there being particular benefit in effective options identification and development processes being undertaken when efforts are being made to achieve relevant policy objectives in areas with relatively low population density. That is, 'traditional' approaches (such as network extension) may prove very high cost on a per customer basis, and thus alternative approaches – including 'non-physical' network approaches – may merit careful attention. This could include focusing attention in relation to wastewater services in some sparsely populated areas on the effectiveness of the collection and treatment processes associated with Home Sewage Treatment Systems.⁵

Affordability, acceptability and deferral risks

As was highlighted above, the bill impacts associated with appropriately addressing future capital maintenance and enhancement requirements may be considerable. The scale of these likely bill impacts will affect the affordability and acceptability challenges that could be expected to be faced if seeking to proceed with such plans. Given this, there is a material risk that appropriate investments may be deferred if the bill impacts are viewed as 'too great'. This kind of deferral of investment might follow an explicit decision, based on an assessment of impacts, and consideration of relevant priorities. Deferral, though, could also emerge more passively, through understandable localised efforts to avoid, or at least limit the size of, bill increases (which may involve giving relatively limited attention to plans that could – if acted on – result in significant upward pressure).

The broader point here is that future tensions associated with bill affordability and acceptability will have to be addressed one way or another. If it becomes viewed as not feasible to increase charges sufficiently to fund investments that have otherwise been identified as necessary/appropriate, and if external sources of funding (such as EU or central government grants) are no longer available, then some scaling down of investment costs will be required. Addressing the efficiency issues highlighted in the above sections can be critical in this context, as it can help reduce investment costs through efficiency improvements (i.e. doing more 'now' for a given bill impact). The alternative in such circumstances is to scale back investment costs by cutting back on scope through deferral (i.e. doing less 'now' and leaving more for 'later').

There is typically some flexibility available in terms of the scheduling of capital maintenance over time and (subject to legal requirements to which they may relate) the timetable for delivering enhancements. This can provide some degree of 'slack' such that a strategy of deferral may have little impact on efficiency considerations for a period. Also, given the extent of recent asset installations in Estonia under the EU funding arrangements, a period of slack is in any case to be expected ahead of some growth in the need for more significant capital maintenance. However, extended periods of deferral can themselves potentially generate additional problems and efficiency challenges.

In some circumstances, this may manifest itself through increased incidents of asset failure, which may then be costly to address. However, because of the long-lived nature of many WSS assets, there can be a significant time lag between significant asset degradation occurring and failure incidents arising. While this time lag can provide significant benefits in terms of the continuity of service provision in the short to medium term, it can also mean that potentially significant asset degradation can have occurred in a way that may be relatively non-visible.

These considerations may raise only limited concerns when maintenance is viewed on an asset-by-asset basis. However, broader concerns typically relate to the potential for such deferral decisions to result in a capital maintenance 'backlog' that it is then not feasible or economic to address in a timely manner. A deferral approach can therefore result in significant problems being stored up for future years in inefficient ways, as instead of adopting a relatively 'smoothed' approach to the management and delivery of maintenance requirements over time (and across the relevant asset portfolio), it may result in clusters of lumpy

requirements that may then be significantly more difficult to address, both in terms of cost and availability of resources and capabilities. Given this, addressing efficiency issues of the kind highlighted in the above sections can be viewed as likely to be critical both in order to try to help address bill affordability and acceptability issues, and – in doing so – to help limit the extent to which deferral tendencies might generate additional problems to be addressed in future years.

A related point is that 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.

4.2.2. Consolidation options and their relevance for Estonian WSS provision

When considering the potential consolidation trajectories that the Estonian WSS sector could take, it seems helpful to distinguish between the following two perspectives:

- A trajectory focused on a particular model of consolidation: the agglomeration of companies on a geographical basis, where well-functioning companies gradually absorb smaller, more fragile ones; and,
- A broader, more open trajectory that could include some consolidation through regional agglomeration, but that could also include a range of different forms of joint operation that do not require a merger, and may be linked to the shared provision of a set of specific functions.

In principle, consolidation benefits could be achieved through either of these routes, but international experience shows that a range of different structures can be used to seek to secure consolidation benefits and thus supports the adoption of the second, broader and more open trajectory. For instance, as mentioned in Chapter 2, not all functions need to be operated at the same scale: water supply could be operated at a different scale than sanitation; investment planning and procurement could be managed at a different scale than consumer relations and billing. Some competences could be available in regional centres, to support smaller utilities. Specific trajectories could be considered for rural areas, which differ from urban ones. As regards managing localised services (including individual sanitation), several options could be considered, from merging, to coordinating local service provision through a public service; such a public service can cover a wide and diverse territory, and could in some circumstances focus on localised sanitation only (as is the case, for example, in France where local SPANC operate and service septic tanks in rural areas).⁶ These varied options (and more) deserve attention, as for their relevance and feasibility in the Estonian context.

A key feature of the WSS reform process in Estonia, however, is the commitment to consolidation on a voluntary basis. This implies that careful attention should be given to the extent to which different trajectories can be expected to be compatible with the incentives that different companies and their municipality owners may face. The section below considers these incentive issues in more detail and highlights the extent to which incentive effects might frustrate the achievement of a trajectory focused on the agglomeration of companies on a geographical basis (i.e. the first option identified above), given the commitment consolidation occurring on a voluntary basis. More generally, the consideration of potential incentives – and importantly, disincentives – to consolidation, suggests that there may be significant benefit in designing the policy framework with a broader, more open consolidation trajectory in mind (i.e. in line with the second option identified above). Some international examples that look to provide particularly relevant and helpful reference points are highlighted.

4.3. Incentives for consolidation

Incentives for consolidation are particularly important to consider in the Estonian WSS context given the focus on seeking to achieve desirable consolidation benefits through voluntary processes. Some more specific questions concerning how the tariff setting arrangements, and other aspects of the regulatory framework, can affect incentives to seek to achieve efficiency benefits through consolidation are considered in Chapter 5. However, it is helpful here to give some more high-level consideration to the question of why consolidation may not be considered desirable by individual companies and/or by their local government owners, as this can help inform thinking on the extent to which different consolidation models might be feasible and/or likely to emerge. In doing so, a distinction can be drawn between the following situations:

1. Where companies and/or their local government owners are unaware or unconvinced of the scope for efficiency benefits to be achieved through different forms of consolidation.
2. Where companies and/or their local government owners consider that there would be likely to be material efficiency benefits that could be achieved through some forms of consolidation, but have concerns over what the effects of seeking to achieve such benefits might be.

4.3.1. Awareness and acceptance of the scope for efficiency benefits

This can be viewed as having a number of different dimensions, including awareness and acceptance of:

- Current performance levels (in terms costs, service quality and environmental outcomes), and how they compare to others and to what might be achievable.
- Emerging performance challenges, including capital maintenance and enhancement requirements of the kind discussed above, and the cost and bill pressures that may be associated with meeting them.
- The scope for delivering improvements through different consolidation options.

There is likely to be significant benefit in seeking to improve awareness and acceptance in relation to each of these dimensions, particularly given the circumstances faced in Estonia, which include that:

- The availability of information on the performance of different WSS companies remains relatively limited, as does the use and publication of comparative assessments. As discussed further in Chapter 6, transparency measures – including the use of “traffic light” style summary tables focused on a relatively narrow set of key WSS KPIs that provide a publicly accessible reference point on relative and company performance - have often been used in other jurisdictions to highlight where performance is poor, and in doing so to motivate company (and owner) recognition of, and response to, this. As discussed further in Chapter 6, while there is an existing broader traffic light type system in Estonia that provides for public access to some WSS information that can be compared across municipalities,⁷ there looks to be scope to provide much sharper reputational incentives through the use of more focused WSS KPI comparisons. This could include the assessment of performance both within and across different clusters of companies that recognised some of the key differences between the circumstances in which companies operate.⁸ A process for developing such an approach is set out in Chapter 5, by reference to a Portuguese example.
- Potential future investment challenges may be viewed (explicitly or implicitly) as insufficient to merit particular attention, when considered alongside the range of more immediate challenges that small WSS companies can be expected to face. Also, given the role played by EU funding in previous years, it may be that the consideration of investment pressures has been viewed as something to be addressed and funded - where necessary - by others (in particular, central government and the EU). This raises a question of whether more clarity (and concreteness) could be provided in relation to what the future delivery obligations and associated investment

requirements of different companies can be expected to be, through the development and publication of regional and/or national strategic planning documents (of the kind used in a number of jurisdictions).

- The limited extent of Estonian WSS company consolidation to date means that there is a lack of clear Estonian examples that can be pointed to as providing evidence of, and a guide to, the sorts of gains that might be achievable. The relatively limited use and transparency of comparative performance management – noted above - is unhelpful in this context, as it can mean that there is a lack of a clear and readily accessible way of demonstrating when relative improvements have been achieved through consolidation. The question also arises as to how information on practical consolidation experiences can be best shared within the sector in order to try to assist other WSS companies and their owners when assessing consolidation options.

The above points may be particularly important in contexts where the senior management and owners of WSS companies may have limited available capacity to consider and attend to longer-term, strategic efficiency and consolidation questions of the kind raised above, given the pressing operational and financial issues that may be faced on a more day-to-day basis. As noted above, increasing the extent of the transparent development and provision of performance information, comparative assessments, strategic planning for the sector, and reports on practical consolidation experiences, can help make the case for greater levels of consolidation more compelling to WSS companies and their municipality owners.

4.3.2. Concerns over the potential for consolidation to have other unwanted effects

In principle, if the consolidation of two companies is expected to result in material efficiency benefits, then one might expect both of those companies to have an incentive to proceed with the consolidation, provided they both expect to be able to secure a reasonable portion of the overall benefit. However, a range of different factors can affect expectations with respect to the securing of future benefits, and thus incentives to proceed with beneficial consolidations.

The following factors look particularly important to consider in the Estonian WSS context:

- Ratchet effects.
- Cross-subsidy and related equity issues.
- The treatment of differences between the WSS charges that are applied by different companies.

Ratchet effects

Ratchet effects can arise because the regulatory conditions that a company faces are likely to be affected by new information that comes available. This can mean that there is a risk that – for a given company - the result of it engaging in successful efforts to deliver efficiency improvements may be a tougher operating environment than it would otherwise have faced. That is, having shown it can operate at lower cost, the extent to which it is allowed to recover costs through charges may be ‘ratcheted down’ by the regulator such that the company is no better off. It is widely recognised that this kind of ratcheting approach can undermine improvement incentives. The underlying issue here concerns the extent to which companies that take steps to deliver efficiency benefits should be allowed to share in those benefits (in order to give them an incentive to identify and deliver them in the first place).

A standard way of addressing this issue is through the use of some form of ‘regulatory lag’, such that charges are only fully adjusted to reflect efficiency savings periodically, with the company able to benefit to some extent from lower costs ahead of that adjustment point. A common approach is for costs to be re-assessed, and prices re-determined, at defined intervals (often every five years), with this providing scope for companies to benefit from savings they are able to make in the period between re-determinations.⁹ The case for adopting this kind of approach is considered further in Chapter 6.

Cross-subsidy and related equity issues

The above effectively assumed that the motivation for consolidation would be the achievement of efficiency benefits. However, the circumstances in some municipalities raise the question of whether the relevant WSS utility would be financially sustainable - on the basis of the charges paid by customers – even with the sorts of efficiency improvements that might be achievable through consolidation. Also, future demographic changes and changes to environmental requirements can be expected to exacerbate these kind of financial sustainability difficulties.

This raises the prospect of larger, more financially secure utilities being deterred from consolidating with smaller utilities that face serious financial sustainability pressures, because such consolidation may end up with them having to cross-subsidise the smaller companies. There may be some circumstances where that does not raise a material barrier to consolidation. In particular:

- If the financial sustainability issues are relatively modest, then the scope for efficiency benefits may be sufficient to offset them.
- There may be other social, reputational and strategic factors that influence the appetite that larger utilities have for consolidation. For example, a company may be willing to bear some degree of cross-subsidy as part of the development of its regional coverage and reputation.

More generally, however, concerns over the sustainability of the funding model of some smaller companies would be expected to act as a material deterrent to at least some forms of consolidation (e.g. the development of integrated regional companies that take on responsibility for serving the smaller company's area). That is, affordability concerns may be sufficiently acute as to undermine the scope for customer bills to fund investment requirements over time (alongside operating expenditure requirements), and this may make the current funding model unsustainable for the company that currently provides WSS services. In such circumstances, it may be necessary to consider social policy tools to support the affordability of water charges, and there may be little prospect of consolidation with other companies being viewed as a feasible option in the absence of commitments related to such support.

Customer charges and the funding of wider environmental benefits

A common tension that arises in the consideration of WSS costs relates to the difference between:

1. The cost of providing the water and wastewater services to the relevant set of customers; and,
2. The costs the relevant water company faces in order to meet applicable environmental requirements.

The equity issues related to (1) can be viewed as relatively straightforward. The long-lived nature of relevant investments can inevitably raise some questions related to intergenerational equity (i.e. how should costs be shared between current and future customers). Beyond this, though, the WSS customers that receive services from a given company can be readily identified (for the most part), and are typically expected to bear the associated service provision costs (subject to acute affordability issues of the kind discussed below).

Equity issues can become more complicated, though, when the costs of meeting environmental requirements are being considered. A common approach is to simply treat any costs associated with meeting environmental requirements as though they are WSS service provision costs, and therefore should straightforwardly be viewed as to be borne by the relevant set of WSS customers. In some circumstances, however, this may not result in a close alignment between those being asked to pay the costs of meeting the relevant environmental requirements, and those who benefit from the requirements being met. That is, there may be significant positive externality effects.

The extent of geographic consolidation can be highly relevant in this context, as it can affect how closely aligned the group that fund specific environmental improvements is with the group that benefits from them. For example, wastewater treatment plants can face stringent and very costly phosphorus removal

requirements that relate to concerns over nutrient levels in receiving waters. It could be viewed that these requirements have widespread benefits across the population, including benefits associated with the meeting of Estonian government commitments in relation to the Baltic Sea. If there was a small number of large regional WSS companies in Estonia, then it may be that there would be little practical difference between who bears the costs of, and who benefits from, phosphorus removal (relevant costs would be shared across a broad range of customers from more urban and more rural localities). However, the fragmented nature of WSS service provision in Estonia may mean that there is a risk of material disparities emerging between the set of customers who bear the costs of, and those who benefit from, some environmental protection measures provided by WSS companies.

The use of EU funds to support environmental improvements in recent years means that this potential source of tension will have been of limited relevance, as – to a large extent – the costs of meeting environmental requirements were not funded by the customers of the particular WSS companies to which those requirements applied. However, as those EU funded assets need to be maintained and replaced, and as other environmental requirements stand to be addressed, this source of tension can be expected to become more important over time.

In practice, the customers of a given company can be expected to both fund some environmental improvements that benefit others, and benefit from some environmental improvements that are funded by other customers (for example, as those other improvements may contribute to the achievement of national commitments, and in doing so confer widely dispersed benefits). The question arises as to whether the fragmented nature of the sector leaves some customers particularly exposed to funding wider benefits, and if that materially affects the financial sustainability of the relevant company.

In terms of consolidation incentives, the key point here is that which was made above: there may be a significant disincentive to agglomerating with a company that is not financially sustainable because doing so may tend to increase the costs to existing customers in order to provide for some degree of cross-subsidy. While such a cross-subsidy may be viewed a reasonable and appropriate from a policy perspective, the question here concerns whether companies (and their municipality owners) would voluntarily seek to cross-subsidise others through an agglomeration process. As is discussed further below, this looks to make it particularly important that a broad perspective is adopted when considering possible consolidation options, because there are a range of approaches that fall short of regional agglomeration through merger in which consolidation benefits can be achieved without requiring this kind of cross-subsidy issue – and the disincentive effects it can bring – to arise.

4.4. Implications for policy approaches to consolidation

The above discussion considered some different reasons why some WSS utilities might be viewed as not financially sustainable (on a forward-looking basis), and described why this may act as a significant deterrent to some forms of consolidation, and in particular to the voluntary formation of broader regional companies. In principle, efforts could be made to address the different factors underpinning the weak financial position that some WSS companies will face. This could include, for example, social policy efforts to support customers that would face acute affordability issues, and/or efforts to provide an external injection of additional funding to address circumstances where customers of a given WSS company have been identified as particularly exposed to funding wider environmental benefits.

Such approaches (if successfully applied) could potentially do much to lessen disincentives to the voluntary formation of broader regional companies that might otherwise apply. However, this would be likely to require considerable policy effort being expended in relation to what may be a relatively large number of small WSS company areas, and the case for prioritising the development of such approaches looks questionable. In particular, one might see the undertaking of the types of detailed assessments and reconfigurations referred

to above, as being something that forms part of, and should result from, the consolidation process, rather than something to be undertaken separately and ahead of that process as a preparatory step.

It is important to emphasise that the incentive challenges highlighted above can be expected to have particularly marked implications for voluntary incentives to develop integrated regional companies. Given this, the above points tend to strongly support the view that it would be appropriate to adopt a policy approach aimed at encouraging a broader range of consolidation models, which includes – but is not limited to - the creation of regional companies. The following two examples of French companies look particularly relevant to consider, in particular to bring benefits of consolidation to smaller municipalities:

- **SDEA:** 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.¹⁰
- **SPANC:** a public service company with responsibilities related to equipment, maintenance and functioning of non-connected wastewater treatment systems: sanitation facilities ensuring the collection, transport, treatment and disposal of all domestic wastewater (except rainwater) from buildings not connected to a public wastewater collection network. SPANC provides an example of how the development of a non-fixed network of responsibilities and collection arrangements can provide an effective alternative to costly wastewater network provision in relatively sparsely populated areas, while providing for appropriate environmental protection.¹¹

Under any scenario, the points raised above apply: 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), reporting on practical consolidation experience (this could be arranged by the association of water utilities), and sharing information on individual and relative performance of service providers.

Notes

¹ Based on data for 2011-15. See Figure 2.10 in OECD (2020), *Financing Water Supply, Sanitation and Flood Protection: Challenges in EU Member States and Policy Options*, OECD Studies on Water, OECD Publishing, Paris, <https://doi.org/10.1787/6893cdac-en>

² For an illustration of this, see Figure 15 (p70) in: https://assets.publishing.service.gov.uk/media/5eda1e5ee90e071b734d2ca7/Northumbrian_Water_Reply_to_Ofwat_response_27.05.2020_NON-CONFIDENTIAL.pdf

³ OECD (2015), *Water and Cities: Ensuring Sustainable Futures*, OECD Studies on Water, OECD Publishing, Paris, <https://doi.org/10.1787/9789264230149-en>.

⁴ Ibid. See also OECD (2020), *Nature-based solutions for adapting to water-related climate risks*, OECD Environment Policy Papers, No. 21, OECD Publishing, Paris, <https://doi.org/10.1787/2257873d-en>.

⁵ See the comments below on the French public service SPANC.

⁶ SPANC is discussed further in a later section.

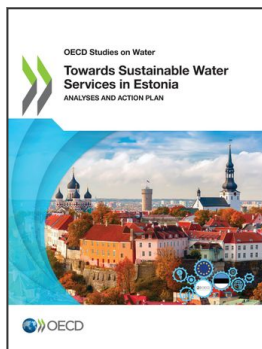
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⁸ Such that, for example, the performance of companies that operate at a similar scale and density could be ranked against each other.

⁹ More sophisticated 'rolling' incentive mechanisms have also been used to try address concerns over the dampening of incentives for efficiency improvements as the next re-determination point approaches.

¹⁰ 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

¹¹ See, for example: https://www.slideshare.net/OECD_ENV/joint-workshop-on-enhancing-efficiency-and-sustainability-of-water-supply-and-sanitation-presentation-benot-fribourgblanc



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