5 Comments on the draft Law on Drinking Water Supply and Wastewater Water Management

While the project was being implemented, Lithuanian authorities developed a draft law to set the scene for future organisation and performance of water service provision in the country. This chapter captures comments by the OECD Secretariat and one international expert on the draft law.

5.1. Introduction

The OECD team was invited to comment on the draft Law circulated by the Lithuanian government to the Parliament. Written comments are destined to support a discussion between the OECD team and the Ministry of Environment. They provide some substance to consider adjustments of the draft Law so that it fits with the ambition of the Ministry. Comments may also provide responses to objections that may be raised in the parliamentary process.

A general comment relates to the level of specificity and detail in some parts of the Draft Law and the potential benefits of a clear delineation between primary legislation (the Law) and secondary legislation (that specifies technical issues in relation to the Law). Indeed, at places, the level of details of technical provisions seems surprising and may be worth consideration. Such level of details triggers risks of unduly inflexible positions being hard-wired into the legislative arrangements and difficult to adjust in the face of new conditions. For example, parts of what is included in **Article 9** [figure in 9(21)] or **Article 15** [in particular, references to specific figures in 15(11)] may be better suited to a subsidiary document that could be given explicit force in the legislation, where relevant principles could be set out. Also, there are a range of time limits for response and decision at various points in the Draft Law, some of which may be better addressed in a subsidiary document, allowing some greater flexibility.

In the note, comments are clustered in three broad categories. The first relates to explicit reference to the ambition of the Law and the leading role of the Ministry of Environment, which sets the tone for other agencies to discharge their duties. The second signals opportunities to refer to and incentivise performance enhancement – and consolidation as an option to promote efficient and sustainable service delivery. The third category refers to the practicalities of core principles in service provision, which should be considered thoroughly to avoid tensions with the emphasis on efficiency and sustainability of service provision.

One caveat applies: comments were provided on the basis of automated translation of the draft Law. While the readability of the English draft was generally good, some misunderstandings may derive from the limitations of such a device. Some ambiguities or apparent inconsistencies may result from automated translation. For instance it is not clear whether entities that transport wastewater or sludge should be licensed or not (apparent discrepancy between **Articles 21** & **24**), or whether shutting individual users who did not pay for the service is allowed or not[1] [**Articles 16(28)**, **20(3)** & **22(2)**].

5.2. Clarifying the ambition of the Law and the leadership from the Ministry of Environment

Section 1 states general provisions as regards the purpose of the Law. **Section 2** goes into quite some depth in the allocation of tasks and responsibilities of several institutions as regards the regulation of the provision of water supply and sanitation services. Sections 1 & 2 could be more closely knitted together if Section 1 stated the ambition of the new law more explicitly and Section 2 insisted on i) the leadership of the Ministry in setting the policy objective and ii) providing other institutions – in particular the economic regulator – with guidance on how they can help achieve that ambition. As regards the level of ambition a more explicit reference to efficiency – and thereby sustainability - of service delivery would make a strong case for the new law and set the scene for the role of the various institutions that contribute to the governance of service provision. Such a reference would justify subsequent incentives to reconsider the way service provision is organised on the ground and explore such alternative options as functional or geographical consolidation.

5.2.1. An explicit reference to efficiency in service delivery

It may be helpful for the 'Purpose of the Law' - as set out in **Articles 1**&**2** – to include an explicit statement in relation to the efficiency objectives that the introduction of the new law is intended to help achieve. That is, it could be said that there are already general requirements associated with the provision of the relevant services in line with what is described in Article 1, and governing relevant relationships in line with what is described in Article 2.

It would seem helpful to explicitly state the purpose of the new law is to facilitate the more efficient meeting of the general requirements currently set out in Article 1. This could be presented as sitting within a broader policy objective of seeking to ensure that service provision and related environmental requirements can continue to be met over time in an affordable and financially sustainable manner. Whether addressed here and/or later (see below), it would seem helpful to make some more explicit reference to the relevance of efficiency considerations.

In line with the emphasis on performance, it is noteworthy that the criteria to become a guarantee supplier [see **Article 15(11**&**14)**] only refer to financial performance and size, and do not factor other dimensions of the operational performance of the service provider. Some minimal level of performance or reference to a benchmarking process would seem in line with the overall ambition of the Law.

Related to the above point, is a question of whether it might be helpful to include some provisions that adopt a more dynamic perspective in **Section 2**. As it is, **Articles 4 – 11** seem to be focused primarily on describing the boundaries of the competencies of the different institutions with regulatory responsibilities. Section 2 can be read in a static way and would benefit from setting the scene for a dynamic interpretation and evolution of governance arrangements. For instance, while **Article 10** sets the competences of municipal authorities in governing water supply and sanitation services, reference could be made to the potential for cooperation across municipalities, in pursuance of economies of scale and scope for service provision.

Moreover, the success of the planned reforms may depend to a significant extent on how different institutions - and most importantly the State Energy Regulatory Council (SERC, as economic regulator) – interpret their duties, and seek to apply the powers and responsibilities they have been given.

This would seem to raise two different sorts of issues which are commented on further in the next few points below, and which relate to questions of whether it would be helpful for the new law to include:

- More in relation to some of the boundary issues that might be expected to arise (as below, the role of the economic regulator in reviewing/assessing 'operation plans' may be one particularly important issue).
- Further scope for the Ministry to influence how duties are being interpreted and applied.

5.2.2. Stipulating the role of the economic regulator

The first point above seems relevant because economic regulators can seek to interpret the scope of their powers in different ways. A critical issue concerns the extent to which the regulator seeks to engage with service delivery issues in the short and longer term. That is, while economic regulators are typically primarily given responsibilities related to charging matters, this has often led regulators to engage extensively with questions concerned with what utilities are delivering in return for being able to levy those charge levels. This follows from the fact that in order to address the question of how reasonable or otherwise a given potential charge level is, it is necessary to consider what is actually being paid for and delivered: what level of service quality is being provided, and how well prepared and resilient are the service provision arrangements to future developments?

An important point here in the context of WSS in Lithuania is that the efficiency of future service provision arrangements may heavily depend on the efficiency of the 'operation plans' that underpin charging proposals (and indeed the efficiency of the infrastructure plans that underpin the operation plans).

This suggests that – in line with experience in some other jurisdictions - it may be appropriate for the economic regulator to have some form of active role in challenging the robustness of operation plans it is being asked to approve funding for, and in particular testing the extent to which alternative options (including different forms of consolidation options) were considered in the development of those plans. In the absence of this, considerable reliance would seem to be being put on the **Article 15** provisions, without there being such a clearly regulatory role in relation to ongoing incentives, and the operation of the price control process.

Under such an approach, while municipalities would retain clear responsibility for the development of such plans, the fact that a plan had been approved at the municipality level would not necessarily mean that the costs identified by the utility as associated with delivering on that plan (even if viewed as reasonable from a narrow perspective) would be allowed by the economic regulator to be included in charges.

To some extent – and in particular in relation to affordability - the Draft Law already explicitly recognises that this kind of tension might arise, and that the regulator may push back on a utility's plan looking for a lower cost alternative. There is a question, though, of whether it would be helpful in **Section 2** of the Draft Law to more explicitly recognise this broader role of the economic regulator in terms of considering service quality and the efficiency of capital plans and their delivery when assessing pricing proposals.

It should be noted that incentives to explore lower cost options should not be limited to "cheap" alternatives: they should invite to explore the potential economies of scope and scale that can derive from different modes of consolidation (sharing of functions, or merging at larger geographical scales). Therefore, explicitly emphasising the role of the economic regulator to pursue cost-efficiency would actively encourage consolidation on an ad hoc basis, in accordance to the bottom-up approach favoured by the government.

5.2.3. Acknowledging the leadership of the Ministry of Environment

The second point above is intended to reflect the risk that various institutions may end interpreting the provisions of the new law in unduly and undesirably limited ways. This could create a context where the Ministry considers that the new law provides a framework that would and should be capable of being used in order to better achieve desired policy objectives, but that is not in practice used that way.

There are a range of reasons why this situation might arise. One concerns legal risks that could arise if new, more progressive approaches were to be adopted, such that institutions –in particular, the economic regulator - may end up having a preference for adopting a more conservative and low risk approach over time. This may be particularly likely if a range of other parties challenge the legitimacy of the economic regulator adopting a more expansive role, and the new law itself provides limited basis for support.

A related issue here is that decisions associated with WSS developments can give rise to material trade-offs that are difficult for regulatory authorities to weigh up, such that their judgements may raise different kinds of legitimacy concerns.

Both of these types of risk could potentially be addressed by including a more dynamic and ongoing role for the Ministry in providing occasional guidance to the economic regulator on factors it should be taking into account when undertaking its duties, and including a requirement for the economic regulator to have regard to such guidance. This approach has been widely used over a number of years in the UK through the provision of social and environmental guidance to regulators from the relevant government department. This is something that could be included in **Section 2** if considered appropriate.

5.3. Alignment with the need to incentivise performance in service delivery

The draft law provides guidance on three sets of issues, which can contribute to - or hinder - cost-efficiency and sustainability of service provision.

5.3.1. Convergence of water tariffs in cases of consolidation

The non-discrimination principle presented under **Article 26** raises some potential incentive problems in terms on 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. The broader point here is that while aligning prices within a region may be straightforward and have only limited impact on any individual customers in some circumstances, there seems to be a reasonable prospect that this will not always be the case, particularly given the extent of price disparities at present. Given this, a requirement for prices to rapidly converge after consolidation has taken place 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 (than they otherwise would) and cross-subsidise other customers as a result of the consolidation going ahead.

The potential adverse incentive effects of this look to merit careful attention. Consideration could be given to adopting a more flexible approach, where the long-term objective of price convergence could be reflected without that translating into a necessary price increase for those customers in the low-cost area in the short-term. Again, more room for manoeuvre would be provided if such considerations were not stated in the Law, but left for further discussion in the context of secondary legislation.

5.3.2. Assessment of costs of service provision

Section 8 provides detailed guidance on the definition of costs of service provision and urges service providers to ensure efficient and reasonable costs (**Article 33**). While this inclination is welcome, it misses the opportunity to look for cost-efficiency beyond the fence of individual service providers. As discussed in previous occasions, the role of SERC, as economic regulator, is to challenge performance of individual utilities and encourage the exploration of performance enhancement through different modes of consolidation, to reap economies of scale.

Performance benchmarking can contribute to this, as it can point at rooms for improvement of development plans and operational performance. Article 33(2&3) could refer to performance benchmarking and performance standards (which would be further defined in secondary legislation), in particular when discussing efficient and reasonable costs.

Similarly, lack of fund and achievement of a “reasonable return on investment” should not necessarily translate into tariff increases, as suggested in Article 33(1). Opportunities to deliver services cost-efficiently and to generate a reasonable return on investment may derive from coordination across service providers and some form of consolidation. Here, consolidation can be an alternative to tariff increases, which would be socially preferable. **Article 33** could be rephrased to suggest that tariff increases could be considered by SERC, after other options to enhance operational efficiency – possibly beyond individual service providers – have been explored. Similarly, **Article 34(15)** could refer to some form of consolidation, as an option to reduce costs

From that perspective, the provision in **Article 34(7)**, which sets a minimal requirement for the volume of investment of merged utilities, may be missing the point. Attention should be paid to the level of service and to service performance, not to the volume of investment per se. Actually, if connection triggers economies of scale, the appropriate level of service provision and performance could be achieved with less investment (economies of scale).

5.3.3. Duration of development plans and tariff reviews

Article 34(4) provides that development plans be set for 3 years (minimum). **Article 34(13)** also requires that tariffs be reviewed on a yearly basis.

There would be multiple benefits to provide for longer development plans and extend the period for which tariffs are set. Longer development plans allow service providers to invest and reap the benefits of their investment, in terms of service provision and efficiency of service delivery.

An extended period for tariff setting would not result in tariffs being set for that duration. The review could provide for a stable mechanism to adjust tariffs, for instance based on consumer price index, labour costs or the cost of energy. The Law could actually provide that best performing utilities or regional service providers could benefit from relaxed supervision and control, and extended periods for tariff setting. This would constitute a further incentive for performance enhancement and for consolidation.

5.3.4. Acknowledging consolidation as an option to enhance efficiency and sustainability of service delivery

While the preference of the Lithuanian government for a bottom-up approach to service consolidation remains, the draft Law could be used as an opportunity to set the scene for more explicit guidance and awareness raising. In addition to comments above on Articles 33&34, the current draft provides multiple opportunities to move into that direction:

- As mentioned above, **Article 10** could include a reference to intermunicipal cooperation as a desirable option to promote efficiency in service provision
- Similarly, **Article 13(1)** could consider the opportunity to devolve responsibility to intermunicipal or regional authorities, where they exist and when appropriate
- **Article 21(6)** could provide more flexibility is to where sewerage sludge should be transported for treatment. Treatment capacity and performance of facilities nearby (but not necessarily n the same municipality) could be factored in
- The definition of effectiveness in **Article 26(3)** could make reference to cost-efficiency rather than to the amount of costs (which in itself is not an indication of efficiency)
- The conditions for granting licences [**Article 27(4)**] or for revoking them could also make explicit reference to operational efficiency and performance standards (which could be defined in the context of secondary legislation).

For the same reason, the requirement to modify licence when the area of operation of a service provider changes can operate as a barrier to change. In principle, if licences are granted on the basis of the capacity of a utility to deliver and reach performance standards, it could be assumed that that level of performance would be achieved in other areas. Licences could then be revoked ex post, in cases where this assumption was proved wrong. Such a principle would provide more flexibility for licenced operators to consider opportunities to operate in other areas and jurisdictions.

More generally, the capacity of the SERC to incentive consolidation could be acknowledged and clearly stated, in particular in reference to the review of development plans, proposed tariffs and expenditure programmes.

5.4. Considering practicalities in relation to core principles for service provision

The Law makes duly reference to core principles for the organisation and financing of water supply and sanitation services, namely cost recovery and Polluter Pays principle. However, it does so in ways that may prevent sound implementation of these principles in the Lithuanian context today. A more flexible or

staged approach may contribute to robust progress towards efficient service delivery and robust financing strategies.

As regards cost-recovery, **Article 18(1)** states that costs 'must cover the necessary costs for… the long-term operation, renovation and development…' etc. As in our earlier briefing note, while this can be expected to be a sensible longer objective for charge levels, there may be undesirable consequences from treating this an appropriate basis for determining the level at which charges should be set in the short- to medium-term. In particular, such an ambition may conflict with incentives for efficiency improvements that the regulator would be otherwise seeking to generate.

Similarly, it may be worth considering whether the presentation of the Polluter Pays principle in **Article 18(2)** presents the responsibility of water sector somewhat too starkly. That is, water sector environmental programmes can often be viewed as addressing broader environmental issues (including those associated with agricultural run-off), and it may be undesirable to present things in such a clear-cut manner. In particular, one desirable water sector response in other sectors has been for companies to try to find ways of targeting other sources of pollution in order to lessen the extent to which broader environmental problems (such as those associated with phosphorus concentrations) are treated as (only) wastewater treatment plant problems.

Note

[1] Note that several EU countries consider shut-off as inappropriate (and indeed unlawful in some jurisdictions) and prefer other options to make users pay. Flow restriction is one option. Note that it is not clear how wastewater collection and treatment can be discontinued in practice when users do not pay their bill.