



Ongoing evaluation of the measure "Renovation and development of the water supply and sewage management systems"

**FINAL REPORT OF THE ASSESSMENT AND
PERFORMANCE OF THE CONTRACT**

Executive Summary

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Vilnius

The main objective of the water management Sector is to provide each individual with access to affordable, continuous, uninterrupted and quality drinking water supply and sanitation services. At the same time, rational use of water resources and protection of ecosystems must be ensured. In order to attain the said objectives, the management reform and institutional strengthening are being carried out, and significant amount of EU structural funds are channelled to the sector.

Based on the National Long-term Development Strategy and National Sustainable Development Strategy, sector-wide strategic goals were identified and subsequently embedded in the Drinking Water and Sewage Management Strategy for the period of 2008–2015 (hereinafter “The Strategy”) approved on the 27 August 2008 by the Resolution No. 832 of the Government of the Republic of Lithuania.

The Strategy serves as a basis for preparation of the legal acts regulating the sector. Also, it has to be followed while projecting the renovation and extension of infrastructure providing for continuous, long-term delivery of socially necessary and affordable water and sanitation services to all customers - both from technical and economical points of view, and the quality of which should meet the specified requirements set for drinking water safety and quality, and sewage treatment.

The goals formulated in the Strategy clearly define directions and tasks for the sector.

First goal is to create favourable conditions to increase the coverage of water supply and sanitation services and to improve their quality.

The second goal is to protect the environment from harmful impact of discharged wastewater. The achievement of these goals shall be measured against the following indicators and their respective target values:

- Water supply and sanitation service coverage not less than 95 per cent of total population;
- 100 per cent of supplied water meets the established quality and safety requirements;
- 100 per cent of collected wastewater is treated in accordance with established norms, and
- Sector reform and improved oversight of water supply companies

By supporting the modernization and extension of the water supply and sanitation infrastructure in agglomerations, a Measure VP3-3.1-AM-01-V “Renovation and Development of Water Supply and Sanitation Systems” of the Cohesion Promotion Operational Program (hereinafter “the Measure”), aims at improved service quality which would meet both environmental and human health criteria.

In order to facilitate the achievement of strategic targets and to improve the absorption efficiency of the allocated EU Structural funds, following aspects had to be evaluated:

- The compatibility of the main legal acts governing the Sector;
- The management efficiency within the Sector;
- The Sector management and institutional strengthening alternatives;
- The role of the National Control Commission for Prices and Energy (NCC)
- Impact of EU Structural Funds on Sector development;
- The indicators set to monitor the achievement of targets defined by the Measure, and
- Identify the trends for the period of 2014-2020

These issues constituted the core of our research. Given the specifics of the Sector, the Study was performed from both economic and legal points of view.

In the course of the work, various evaluation methods, which complement one another, were used, i.e. analysis of primary and secondary sources, deductive and comparative tools, in-depth interviews, expert assessments, simulation of various scenarios, and analysis of the feedback provided by beneficiaries of EU funds (interviews and case studies).

All the information required for the research was collected. Using the above-mentioned methods resulted in our conclusions and recommendations.

Efficiency of water management sector and the companies

The goals of the Strategy are set forth with great ambition. Large-scale investments and competent planning are required for the achievement of these goals, so that the services to customers were delivered on optimal terms. The allocated EU funding in the 2000-2006 period amounted to more than 1.3 billion LTL, and to more than 2 billion LTL in the period of 2007–2013.

However, the analysis of water company operations carried out in the framework of this Study, suggests that not all strategic goals will be achieved. Operations of water companies for the moment are inefficient, and the supervisory institutions do not enforce sustainable development of the sector. The Study came to the following main conclusions:

- Currently, the coverage of water supply and sanitation services is significantly below the levels projected in the Strategy. As for the time being the EU funds remain the only funding source, it is highly unlikely that the projected service coverage rate will be achieved by 2015.
- In the course of analysis, a number of drawbacks were identified which result in financial unsustainability of the sector. First of all, the majority of the companies for many years have been operating at loss. Also, the pricing principles do not ensure implementation of the cost-recovery principle. Depreciation cost of the EU funded assets is not included into the prices of services. Therefore, capital is not being accumulated for the future when all fully depreciated assets will have to be renovated, and, thus, the sector has become dependent on the subsidies. The companies have not performed detailed stocktaking and valuation of their assets. Furthermore, a part of the company assets remain on municipal balance sheets. That, in turn, artificially improves financial condition of the companies since depreciation of such assets (belonging to the municipalities,) is not included into the financial statements of the water companies. As a result, all actual costs are not taken into account when the prices of services are being calculated. The benchmarking with Estonian and Scottish water companies demonstrated that the efficiency of Lithuanian companies is lower, and relatively higher staff numbers in Lithuanian companies are particularly evident.
- Issues relating to expertise and human resource capacities were identified, especially in small water management companies and municipalities. Due to deficiency of human and financial resources, managers of the water companies are forced to spend most of their effort for the administration of the EU funded projects and organization of the public procurements, and, therefore, insufficient attention is paid to strategic issues. For example, the interviews with the company representatives revealed that companies quite often lack the long-term vision, they have not in place neither long-term strategies, nor investment projections; economics of alternative development projects are seldom considered or assessed.

The above mentioned problems suggest that in order to achieve sustainability of the water sector a major reform is indispensable, as in the long run neither the expectations of the customers, nor Lithuania's international obligations will be fulfilled. The alternatives of the sector reform, which would essentially provide for solving of the identified problems, were assessed.

We came to conclusion that in order to achieve full cost recovery, the consolidation of the sector would be the preferred and most efficient way to go due to economies of scale, improved management and balancing of service cost to customers. The consolidated companies would be in position to run sustainable operations based on revenues from their core business. Consolidation in the water sector can be implemented in a number of ways, for example, at municipal, county, river basin, the large city, or at national level. Economic assessment allows concluding that the regional level would be optimal for company consolidation. In range of 3 to 10 water companies could eventually operate in Lithuania.

Recommendations on how to implement the water sector consolidation are based on analysis of the legal framework, and are provided in Chapter dealing with legal analysis.

Division of functions between the NCC and municipalities

In the course of the Study, the relationship between the National Control Commission for Prices and Energy (NCC) and municipalities was analysed. The analysis covered the pricing process, as well as the planning and implementation of service extension. Based on analysis of international practice, current issues of the pricing process for the water sector and on our own findings, we conclude, that while both NCC and municipalities participate in pricing process, their actions are poorly coordinated. Due to the fact that municipalities in respect to water companies can not be considered as impartial and fully objective due to their legal status, it is recommended to change the tariff setting mechanism in a way that this responsibility is assigned solely to the National Control Commission for Prices and Energy (NCC). Also, we propose an introduction of better control over preparation of the water company development plans, which would contribute to implementation of the cost recovery principle and proper use of the EU funding.

The EU funding for the period of 2007–2013

European Union has been the main funding source for implementation of the Drinking Water and Sewage Management Strategy in the period of 2008–2015. 2.7 billion LTL of these funds have already been disbursed and resulted in construction of additional water and sanitation infrastructure. In 2004, the value of the material assets of the companies regulated by the National Control Commission for Prices and Energy (NCC) amounted to only 2.1 billion LTL, while by 2011 it had increased to 4.5 billion LTL. The creation of the majority of these assets was financed by EU funds.

The Measure has had a positive impact upon the water sector in Lithuania. Service coverage and compliance with the environmental standards and requirements has significantly improved (for example, the major part of collected sewage is treated according to prescribed norms). The sludge treatment projects financed by the EU funds could be commended as an example of best practice. Projects were based on a feasibility study, which defined the objectives and investment needs for processing of the entire amount of sludge generated in the country. The Measure has also provided the opportunity to implement the cutting edge technical solutions in the water management sector.

According to the opinion of the interviewed water companies and municipal representatives, in absence of EU funding the current projects would not have been implemented or the scope of these projects would have been significantly smaller, and the objectives of the projects would have been less ambitious. The State would have encountered additional challenges in complying with respective EU requirements.

The Cohesion Promotion Operational Program provides that by 2015 the coverage of water supply and sanitation services should increase by 8 percentage points or by about 270 thousand people compared to the year 2006. However, the signed funding agreements provide connection of only 150,000 new residents, which roughly accounts only to half of projected numbers. The water

management sector companies surveyed (except of the 4 companies which face certain difficulties) have indicated that the obligations assumed in the financing contracts with respect to the connection of the new users will not be achieved. One of the main reasons why other projected indicator values may not be reached is flawed planning process (insufficiency of consistency in the assessment of financing demand and conditions). Simultaneously, residents are being connected to the service network built during the previous financing period. However, the target values of the other indicators, namely, for the number of agglomerations in which EU funded projects are being carried out, and the number of the sludge treatment projects will be achieved.

The selected funding priorities and activity areas for the Measure essentially address the sector needs. Funding is offered to areas, which are significantly lagging behind the long-term objectives of the sector. However, the Measure could have been instrumental in facilitating the water sector reform (implementation of the licensing, establishment of the public suppliers, aggregation of the companies). Also, the high intensity of grant funding - the subsidy levels exceeding 90 per cent of the total project cost (over 80 per cent of EU funds and around 10 per cent of National Budget co-financing) does not stimulate the water companies to look for the most efficient projects and technical solutions.

As the cost recovery principle is not being implemented and investments are still financed mostly by EU funds, the long-term sustainability of the sector is impossible. Without cost recovery and profitable operations in place, the water companies are dependent on subsidies and consequently cannot perform investment activities on their own. For instance, numerous water companies had not been investing in network renovation despite significant losses due leakages and infiltration.

Trends for the period of 2014–2020

It is important to revise the Strategy prior the planning of the new Multiannual Financial Framework (MFF) commences. The target values of indicators and target dates for their achievement should be revisited with due respect to availability of funding. It is recommended to consider the possibility of changing the requirement of service coverage from 95 per cent in each municipality to overall 95 per cent in Lithuania. In addition, it is recommended that service coverage was measured in numbers of connected dwellings (alternatively - households) instead of residents. The methodology for calculation of this indicator still has to be developed and NCC shall be designated as responsible institution for monitoring the progress.

The municipalities have communicated that in their assessment the funding need for the new MFF is in range of 16 billion LTL. For comparison, in the course of preparation of the Strategy for the period of 2008-2015, it was assumed that 3.4 billion LTL would suffice to achieve specified targets. Based on the analysis of the municipal Special Development Plans, we estimate that investment need for achievement of the Strategy goals is in range of 3.9 billion LTL.

It is proposed to maintain the continuity in the new financing period of 2014-2020 and to use EU funding to finance the extension of the water and sanitation networks. However, taking into account the needs of the water companies and entire sector, we propose to allocate more funds for renovation of networks, improvement of water quality and storm water management.

Within the scope of this Study there was no possibility to determine exact funding needs for development of the storm water infrastructure and improvement of drinking water quality. Therefore, it is proposed to perform separate detailed studies. Also, it is recommended to assign sufficient funds to be used by the water companies for stocktaking and valuation of their assets.

While planning the investments in the new MFF, it is recommended to prioritize economically viable projects, e.g. reconstruction and renovation of networks, and once the needs are defined - the

storm water treatment, which could be financed by means of financial instruments (FI). Network extensions, improvement of water quality and wastewater treatment efficiency could be financed through the Investment fund by combining loans and subsidies.

If, however, a decision were made to maintain the grant funding, it is recommended to stick to the National Project Planning method, except the share of grant funding should be lowered and differentiated. It is recommended applying that financing intensity 70 per cent grant element for the network extension, the water quality improvement and wastewater treatment projects. Network renovation and storm water treatment projects should qualify for not more than 50 per cent subsidy of the total project cost.

Financial Instruments and opportunities for Public Private Partnerships

In order to answer the question as to what are the possibilities for using Financial Instruments (FI) and Public Private Partnerships (PPP) in the water sector, a number of alternatives were analysed. Given the favourable legal framework and based on the best practice, we recommend adopting the concept of the Investment Fund. Investment fund would allow to create favourable conditions for attraction of private sector funds and "to employ" the EU funds. It means that funds will not be distributed in form of subsidies; rather, they will attract additional private sector funds, in conjunction to which it would be invested directly into the water companies or offered as targeted loans. Later on, such approach would allow not only recovery of the invested funds but also would offer return on investment. In order to clarify what is required for practical application of these methods and what would be their efficiency, a number of alternatives and related systemic elements were analysed; conditions and necessary prerequisites for the application FI and PPP in the water sector have been specified. We can assert that along with the ever increasing funding need in the water sector and shrinking intensity of the EU funding and other subsidies, the application of the PPP and FI offers tremendous potential for solving many problems related to raising of funds, and creating additional added value, since the efficiency of the water management sector would be increased. The main conditions for efficiency gains in the water sector through application of the PPP models and FI are as follows:

- Political support (long-term commitment);
- Proper legal regulation;
- Selection of proper projects;
- Balanced risk sharing among the partners;
- Detailed risk management plan and proper controls during the entire process.

Legal regulation of the sector

The Study analysed various aspects of the water sector: consolidation of the water companies, the service coverage, the mechanism for setting the optimal prices for and the quality of the water and sanitation services. These areas were selected with due respect to the Strategy which is one of the main legal acts setting the goals and tasks for entire water sector. The legal part of the Study attempts to determine whether the current legal framework is compatible with the EU law, i.e. whether the Urban Waste Water Directive, Water Framework Directive and Drinking Water Directive have been properly transposed into the legal system of Lithuania, and whether the legal regulations are compatible with the Strategy, and whether they create prerequisites for the implementation of the Strategy. Also, the influence of the EU funding on the implementation of the Strategy was analysed with respect to each of the above-mentioned aspects, i.e. whether the EU funding was granted with due respect to the goals of the Strategy. The relationship between the National Control Commission for Prices and Energy (NCC) and municipalities in the context of water sector was analysed in the second part of the legal chapter.

The legal analysis of the water sector with respect to the consolidation of companies revealed that this process is linked to appointment of the public and regional water suppliers, which is responsibility of the municipalities. It should be noted that municipalities are not active enough in fulfilling this obligation.

The Study highlights the following problems of legal regulation problems related to the consolidation of the companies:

- Exceptions in the law permit the non-public water suppliers to provide water and sanitation services;
- Only a limited number of subjects can bid for being selected as a public water supplier;
- Obligation to obtain the license for providing the water and sanitation services applies only to public water suppliers

We propose to abolish the exceptions which allow the non-public water suppliers to deliver the water and sanitation services. Also, we suggest broadening the scope of the subjects eligible to participate in the public water supplier selection tender.

Lithuania has opted for a voluntary process of company consolidation. However, the Study came to conclusion that it was not efficient. Therefore, we propose to use incentives to facilitate the process. Ministry of Environment has sufficient authority to streamline the consolidation of companies by using EU funding as additional incentive. Ministry of Environment shall consider modifying of EU funding award procedures so that only the public and/or regional water suppliers that are in position to recover all costs would qualify. Alternatively, it is proposed to amend the law so that it would clearly state that only public and/or regional water suppliers were eligible for EU funding. (The course of action will depend on discretion of the legislator.)

From legal point of view, the licensing is considered to be one of the most efficient tools for ensuring the quality of water services. In accordance with the current legal regulation, only the public water suppliers are required to possess operational license. However, in order to implement the Strategy and ensure compliance with the human health and environmental as well as the service quality standards as set forth in the legal acts, and in order to provide as many as possible residents with publicly supplied water on optimal terms and conditions, we recommend to increase the number of the subjects who need the license to operate. We recommend to introduce a legal requirement to possess the license should not be limited to public water suppliers.

One shall consider introducing an additional criterion to be met by EU funding applicants, namely, the possession of operational license. Application of this criterion would be especially important in case the draft Law was adopted, since it provides for all water suppliers without any exceptions (not only the public suppliers) to possess the license. Such a condition would stimulate the applicants seeking EU funding to comply with legal acts and to operate exclusively with the licenses.

The Strategy stipulates that by end of 2015, at least 95 per cent of residents in each municipality shall benefit from water and sanitation services provided by public water supplier. This is why we analysed legal preconditions for increasing the service coverage. Based on the interviews with the representatives of the water companies, we identified the following impediments preventing the increase of service coverage:

- Absence of obligation to connect to the services delivered by the public water supplier;
- The connection fee to obtain the service;
- Reluctance of the residents to pay for the water supply and sanitation services;
- Organizational deficiencies;
- Insufficient environmental awareness of the residents.

The above mentioned negative factors could be eliminated or alleviated by amending or supplementing the legal acts regulating the water sector, for example, by denying the residents the right to treat the sewage at individual installations. In situation when the water supplier has provided the residents with a possibility to connect to water and sanitation services, no new individual wells and wastewater treatment installations shall be permitted.

Having analysed the procedures for award of EU funding we conclude that the current edition of the Description of the Funding Terms sufficiently provides for increasing the service coverage. Therefore, similar legal provisions shall be maintained in documents regulating the granting of financial support in the 2014-2020 funding period.

The water pricing mechanism, which hinges on the cost recovery principle embedded in the Water Framework Directive was analysed from the legal point of view. Member states were obliged to transpose this legal act into their own legal systems by 2010, and it should be complied with while setting the tariffs of the water and sanitation services. The Study confirmed that this principle had been properly transposed into Lithuanian legal system (the said principle is set forth in the paragraph 31(1) of the Water Law of the Republic of Lithuania, the Law and the Price Setting Methodology), however, more specific legal regulation is needed for proper implementation of the cost recovery principle, in absence of which the enforcement of legal acts faces difficulties. We believe that this is the main reason why the majority of water companies have not been able to implement the cost recovery principle.

Analysis of the pricing mechanism allowed highlighting its main problems:

- The existing pricing procedures are not uniform;
- Validity of tariffs is open-ended, and water suppliers do not review them for unreasonably long periods of time.

The said problems are caused by insufficiently clear and precise legal regulation; therefore, the Study offers to amend the relevant legal acts, i.e. it is proposed to introduce uniform price setting procedures and to establish a specific time frame for validity of tariffs.