



**ENVIRONMENT DIRECTORATE  
ENVIRONMENT POLICY COMMITTEE  
TASK FORCE FOR THE IMPLEMENTATION OF THE ENVIRONMENTAL ACTION  
PROGRAMME FOR CENTRAL AND EASTERN EUROPE, CAUCASUS AND CENTRAL ASIA**

**Issues Paper**

**Financing water supply and sanitation in EECCA  
Conference of EECCA Ministers of Economy/Finance, Environment and Water and their partners from  
the OECD**

**17-18 November 2005, Yerevan, Armenia**

*This Issues Paper has been prepared to help guide discussions at the Yerevan Ministerial Conference. Its structure corresponds to the main agenda items. Background papers have also been prepared, in most cases with short, policy relevant summaries, to provide a solid analytical basis for discussion. The background papers and their linkage to the agenda are identified in annex 2 of this paper.*

## ISSUES PAPER

People's access to water and sanitation in EECCA countries generally has not improved since the Almaty Conference in 2000<sup>1</sup>. At that time, water infrastructure was assessed as being in a critical condition. Since then, it has deteriorated further, aggravating health risks and economic impacts. However, there have also been more positive developments:

- Opportunities for financing the sector have improved as economic growth has rebounded and helped improve the financial situation of public budgets, enterprises and households, and
- There are now some examples of successful reforms, and tools<sup>2</sup> to support reform, that could be applied throughout the region.

The key challenge is to find ways to work with the improved economic conditions and to scale-up the successes.

### Assessing Progress

The portion of urban populations having access to centralised water services in EECCA countries remains at a high level, but the *quality* of that access has deteriorated: disruptions of water supply, pipe breaks, and unaccounted-for-water have steadily increased in recent years. Similarly, key financial indicators have not shown improvement. On these trends it is unlikely that that the water-related Millennium Development Goals (MDGs) will be achieved by 2015<sup>3</sup>. However, official estimates of progress in this regard are not reliable and paint an overly-optimistic picture. Improved methodologies and better data are needed to provide a more reliable basis for tracking progress, priority-setting and elaborating MDG-focused development strategies.

The consequences of deteriorating water infrastructure on public health, the environment, and economic development in the region are serious. WHO estimates that in the UN ECE region more than 13,000 children under the age of 14 die every year from poor water conditions, probably most of them in the EECCA region. The social benefits of improved water supply and sanitation would be significant. WHO estimates that the cost-benefit ratio from investing in water infrastructure in a group of European, Caucasus, and Central Asian countries could be as high as 1:13, with one currency unit invested yielding 13 in return.

While the overall trend is broadly the same across the EECCA region, the state of water services and their adverse impacts is quite diverse. Some positive achievements have been registered in the richer EECCA countries, and in some capital and large cities. However, the situation is much worse in small and medium sized cities, and water services in many rural areas have collapsed following the dismantling of the collective farm system. Thirty-six per cent of the population in EECCA live in rural areas, underlining the importance of more effective programmes in these areas. More generally, the situation in the poorest

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<sup>1</sup>. See OECD (2001) "Water Management and Investment in the New Independent States". Amongst other things, Ministers adopted Guiding Principles for the reform of the urban water sector in the EECCA region. The Guiding Principles have provided the framework for a work programme that has been implemented by the EAP Task Force and they provide an important reference for the present Conference.

<sup>2</sup>. Some of the tools developed by the EAP Task Force in this respect are listed in Annex 1 to this document.

<sup>3</sup>. The water-related MDGs aim to reduce by half those people without access to safe drinking water and basic sanitation by 2015.

EECCA countries is much worse than in the more affluent states, especially in terms of water quality and resulting health impacts.

A review of the major institutional and legal reforms in EECCA indicates that many countries have undertaken measures to improve the situation in the water supply and sanitation sector, most of them in line with the recommendations set out in the Almaty Guiding Principles. In particular, central governments have improved the institutional set-up for the water sector, and developed framework legislation to better guide local level actors, mainly in setting tariffs. However, there are only a few examples where the water-related MDGs have been integrated into national development plans or, where appropriate, Poverty Reduction Strategy Papers<sup>4</sup>. Moreover, much more could be done to inform the public and to engage them in discussions on how to improve the delivery of water services.

#### Issues for discussion

What measures have been most effective in driving the reform of the urban water sector and improving the delivery of water services? What are the critical factors holding back reform? How can best practice examples be replicated and scaled-up?

What are the main challenges in the rural water sector and how can they best be addressed?

#### Financing Water Infrastructure

In many EECCA countries, water utility revenues only cover about 60 per cent of operational costs. As a result, utilities have had to decrease levels of service and cut back on basic maintenance, further accelerating the deterioration of infrastructure. Resources for rehabilitation or new investments are even scarcer. Thus the water sector in many EECCA countries is caught in a vicious circle of financial unsustainability and declining service provision.

It has been estimated that between USD 15-34 per capita per year of additional finance would be needed if present infrastructure were to be properly maintained and renewed. This corresponds with about EUR 7 billion per year that would be needed to achieve the water-related MDGs, roughly double the current level of finance.

There are no simple solutions for meeting the finance challenge. EECCA countries will have to combine all sources of finance to enhance synergies, avoid crowding out other sources, and maximize leverage on total flows. Finance Strategies elaborated by a number of EECCA countries in cooperation with the EAP Task Force have provided insights into some of the main elements of EECCA country approaches:

- The operational efficiency of water utilities needs to be significantly improved in order to reduce operational costs. Energy costs and unaccounted for water are 2-3 times higher than in OECD countries. However, achieving efficiencies often requires up-front finance for investments.
- User charges, combined with improved billing procedures, will continue to be the major source of finance, particularly for operational and maintenance costs. However, a clearer distinction is needed between the economic and social dimensions of water so that tariff levels allow utilities to be financially autonomous while support measures are better targeted to ensure that poorer

<sup>4</sup> Achieving the water-related MDGs in the EECCA region will be the subject of discussion during the Ministerial lunch. During the second preparatory meeting for the Yerevan Conference it appeared that there were important differences between EECCA countries and donors with regard to the MDGs: the water-related MDGs have not been integrated into national development strategies in most EECCA countries, but that achieving the MDGs was a high priority for donors.

households have access to water services. User charges will also help to decrease the excessive demand for water which is far higher per capita than in OECD countries.

- Public budgets will be essential in most countries, particularly for capital costs. Given the current stage of development in fiscal federal relations in most EECCA countries fiscal transfers from central and regional authorities to the local level have a particularly important role to play. They should be designed to provide a predictable stream of revenues and incentives for sound financial management at the local level.
- Affordability constraints are leading some governments to confront the politically sensitive choice of either providing a smaller number of urban residents with in-house connections, or a larger number with access to communal stand-pipes.
- Finance strategies for the water sector should be developed within the framework of Integrated Water Resource Management schemes and integrated into binding budgetary procedures such as medium-term expenditure programmes.
- Official Development Assistance (ODA) and finance from International Financial Institutions will play a small role in terms of total flows, but they may nevertheless have an important demonstration and catalytic role. There is potential for greater flows from these sources, particularly if reforms can help convince donors that the resources would be well-used. Increased ODA would be essential if the water-related MDGs are to be achieved.
- The private sector is unlikely to be a significant source of investment capital for the foreseeable future in most EECCA countries; it is more likely to be a source of managerial and technical know-how (see below).
- Local capital and financial markets are unlikely to be a major source of finance in the short-term; though opportunities may be emerging in the larger, richer countries like Russia and Ukraine.

#### Issues for discussion

What can be done to put the water sector on a more financially sustainable basis by moving toward tariffs that at least cover operational and maintenance costs while addressing legitimate social and political concerns about the affordability of tariffs?

How can central government resources be used most effectively to support the improvement of water services at local level?

#### Relations between Municipalities and Utilities

Slow progress in reform at the municipal level is arguably the single biggest obstacle to improved provision of urban water supply and sanitation. There are a number of positive examples where municipalities have adopted plans with clear objectives and identified the means for achieving them (e.g. Surgat and Yaroslavl in Russia and Yerevan in Armenia). Some of these have begun to manage their finances and have become sufficiently creditworthy in order to take on debt to finance the construction or rehabilitation of water infrastructure. However, these cases are very much the exception. A huge effort is needed to roll-out and replicate the positive experiences in municipalities throughout the EECCA region.

Local authorities in EECCA need to commit, and require support in order, to:

- set consistent, stable objectives for the water supply and sanitation sector as part of city or regional master plans and with clear links to Integrated Water Resource Management plans

- elaborate realistic finance strategies to achieve these objectives
- translate these strategies into rolling, medium-term investment programmes, rather than the annual programmes that many municipalities currently follow, and
- promote public participation in the development and implementation of these activities.

A critical element of reform at the local level concerns the relations between local governments and utilities. Previously, utilities were departments within local government, and the authorities were *de facto* service providers. However, international experience demonstrates that the governmental functions of policy and regulation should be clearly distinguished from the responsibility of utilities to provide water services. Performance contracts between municipalities and utilities can be helpful in clarifying the relative roles and responsibilities of the two sides, and in creating a structure of incentives that rewards good performance by utilities. However, effective performance contracts are still rare in EECCA countries.

The management, organisation and capacities of utilities need to be enhanced as part of the reform at the local level. At the Almaty conference, there had been hopes that private sector participation in the operation of utilities would help to drive this process. Generally these hopes have not been realised. International operators have become more risk averse, in part because of uncertainties about the legal and political framework. Most are not prepared to invest any of their capital and prefer relatively low-risk forms of engagement such as management contracts as a first step into EECCA markets<sup>5</sup>.

The Russian Federation is an exception in this regard. Following positive political signals, domestic private companies had established contracts in 20 cities by September 2004, supplying water to about eleven per cent of the urban population. This is high by international standards. However, most of these contracts are short-term leases and the sustainability of their involvement in the water sector is not clear at this time.

#### **Issues for discussion**

*What steps should be taken to enable local authorities to provide more effective direction, support and regulation of water utilities?*

*What are the main opportunities and obstacles to further private sector participation in the water sector?*

<sup>5</sup> A Roundtable discussion on Public-Private Partnerships in the water supply and sanitation sector of EECCA countries will be held in conjunction with the Yerevan Ministerial Conference on 17<sup>th</sup> November, 16.00-18.30. The results of the Roundtable will be reported to the Ministerial meeting.

## ANNEX 1

### **Some of the main tools developed by the EAP Task Force to support reform of the water sector in EECCA countries**

- *Financing Strategies*: A computer tool (FEASIBLE) that allows the identification of realistic infrastructure development objectives, taking account of available financial resources. The tool helps clients to develop their understanding of the real financial needs and to adjust their objectives accordingly. It helps to create an objective basis for discussions among ministries and with donors and IFIs about the scale and ambition of possible investment projects.
- *Multi-Year Investment Planning Tool for municipalities (MYIP)*: This tool allows municipalities to plan their water sector and other investments on a three-year horizon. It helps establish some basic financial planning capacity in local governments and supports the preparation of coherent municipal investment programmes.
- *Financial planning tool for utilities*: This tool enables utility staff to develop basic skills in sound financial planning and to prepare corporate development plans. It complements the MYIP tool.
- *Toolkit for benchmarking water utility performance*: This tool is based on a methodology developed by the World Bank. It supports the development of more performance-oriented thinking in utilities and governments and can be integrated both into day-to-day utility management routines in utilities and into contracts between municipalities and utilities.
- *Guidelines for the development of performance based contracts between municipalities and utilities*: They provide a general introduction to the issue of performance based contracting, including their key contractual elements and practical experience in developing such contracts. They should help to prepare municipal and utility staff for a more formal structuring of their relationship as is usually required in the framework of IFI/donor projects.
- *Good Practices for public environmental expenditure management*: A pragmatic checklist to assess the performance of programs and institutions that manage public environmental expenditure, and guidelines to improve their performance.
- *Handbook for appraisal of environmental projects financed from public finance*: This tool is aimed to help governments develop methodologies for effective appraisal of water and sanitation projects in order to support the effective allocation of scarce public funds. It should support the development of a list of priority investments in national and regional governments, and improve the realism of project proposals, as well as the political commitment that comes along with them. It supports implementation of Good Practices of public environmental expenditure management.

## ANNEX 2

**List of background papers that support the different agenda items of the Conference**

<b>Session I</b>	
<b>Assessing progress on implementing the Almaty Guiding Principles and the water related MDGs</b>	
Progress on implementing the Almaty Guiding Principles for the Reform of the Urban Water Supply and Sanitation Sector in EECCA	ENV/EPOC/EAP/MIN(2005)2
Meeting the Millennium Development Goal Drinking Water and Sanitation Target in the EECCA region: a goal within reach ?	ENV/EPOC/EAP/MIN(2005)3
Water supply and sanitation in rural areas of EECCA	ENV/EPOC/EAP/MIN(2005)4
Health aspects of cost-benefit analysis in water supply and sanitation (by WHO)	ENV/EPOC/EAP/MIN(2005)9
NGO Position Paper	ENV/EPOC/EAP/MIN(2005)10
<b>Session II</b>	
<b>Ensuring sufficient finance for the effective operation, maintenance and investment of water infrastructure</b>	
Financing water services and the social implications of tariff reform	ENV/EPOC/EAP/MIN(2005)6
<b>Session III</b>	
<b>Reforming relations between local governments and water utilities, including the role of the private sector</b>	
Reform of Water Supply and Sanitation in EECCA at the Municipal Level	ENV/EPOC/EAP/MIN(2005)5
Position paper by the international private sector on its role in the reform of water and wastewater utilities in Eastern Europe, Caucasus and Central Asia	ENV/EPOC/EAP/MIN(2005)7
Domestic private sector participation in the Russian water sector	ENV/EPOC/EAP/MIN(2005)8