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## **POLICY ADVICE**

### **on the Road Map to Develop the Water Sector in Ukraine**

The present paper was prepared by the Directorate of Democratic Institutions, Directorate General of Democracy and Political Affairs, in co-operation with Prof. Gérard Marcou, University Paris 1 Panthéon-Sorbonne, Director of GRALE (Research Group on Local Administration in Europe), France.

## **Introduction**

The present policy advice was requested by the Ministry of Regional Development, Construction, and Communal Services within the framework of the Council of Europe (CoE) Programme to Strengthen Local Democracy in Ukraine (2010-2013, funded by the Swedish International Development Cooperation Agency Sida). The reform of communal services includes discussion on the decentralisation of water services. On 7 June 2011, the Council of Europe experts participated in the Water Forum in Yalta. This paper reflects the discussion and provides some basic recommendations on the current draft Road Map on Decentralisation of Water Services. A more detailed legal appraisal of the new draft law can be prepared as the next step.

Three laws were adapted recently in order to set up a new legal framework deemed to upgrade the water system in Ukraine:

- The law on corporatisation, according to which municipal enterprises (“unitary enterprises”) in the sectors of water supply, sewerage and heat supply can be transformed into limited companies with public share-holding and own assets; the law makes private share-holding possible but not necessarily privatisation, since several categories of assets may not be privatised;
- The law on concession and lend-lease contracts for water supply, sewerage and heat supply; depending on the contract, the infrastructure is established and operated by the concessionaire or only operated by the lessee for the local authority;
- The law on the national regulator: this law has established a national regulator for all services of the communal economy organised on a network basis (water supply, sewerage, heat supply) and for housing management. As regards the water sector as a whole, the national regulator is a central executive authority with legal personality in charge of licensing, pricing and supervision, and not the local authorities, with a number of significant exceptions<sup>1</sup>.

Although this system has only been in place since 2010, it would seem that it is not satisfactory, since the “Road Map” on water supply and sewerage published already in October 2010 designs a strategy based on different principles.

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<sup>1</sup> In 2008, the CoE experts advised against the creation of the National Regulator.

The paper will comment first on the Road Map with regard to the existing regulatory framework and the inconsistencies embedded in it; the second part discusses the directions indicated by the Road Map with additional suggestions.

## **I. The Road Map strategy and the recent legislation on water supply and sewerage**

### *A) The principles of the Road Map strategy*

While the principles set out by the Road Map document do not conflict directly with the three pieces of legislation mentioned above, neither are they fully consistent with them. The strategy put forward by the Road Map is based on the following principles:

- Support the development of inter-municipal cooperation (IMC) aimed at establishing aggregated administrative-territorial units (ATUs) on the scale required by an efficient management of water supply and sanitation;
- Reform the regulation by extending the scope of the national regulator, in order to have one national regulator for all utilities serving more than one territorial community (*hromada*), e.g. in all future aggregated ATUs (at present, the national regulator is competent only for 68 utilities);
- Organise the State administration's technical and methodological support to aggregated ATUs in order to help them negotiate with the private sector on an equal footing;
- Establish and implement water resource development planning at the regional level, based on cooperation between several aggregated ATUs;
- Improve the control of the quality of drinking water by the aggregated ATUs with the support of the State administration.

To sum up, the main idea is to shift the major responsibility for water supply and sewerage to local authorities based on IMC designed for water sector, and at the same time extend the responsibility of the national regulator.

The difficulties arise from the implementation of the regulatory framework resulting from the three laws mentioned above. The CoE expertise of the three draft laws provided to the Ukrainian Government in September 2008 already pointed out several inconsistencies. These

were discussed in depth with the parliamentary committee responsible for communal services at that time, and CoE did not support the establishment of the national regulator.

The main problem of the present system is that it is a hybrid of three different models of regulatory frameworks, the different pieces of which are not consistent with each other.

### *B) Main models of water and sewerage service provision*

According to the results of international comparisons, already mentioned in the 2008 analysis that have now been published<sup>2</sup>, three main models are prevalent in European countries. It will be easy to see the elements that can be used in the present organisation of the water and sewerage sector in Ukraine. These basic models<sup>3</sup> can be summarised as follows:

#### 1) The local public sector model

The service is delivered by a municipal public enterprise, which in the past would not have had legal personality. Nowadays organisation and management have diversified, but the operation by a public enterprise prevails. This model is typical for Germany and Italy. The public sector presence is even stronger for sewerage than for the water supply.

In Germany, water supply and sewerage are carried out mainly by municipal public enterprises, either as public law corporations or as commercial companies, the capital of which is held by municipalities, sometimes with minority private shareholders. Private companies represent only 0.6% of the companies of the sector.

In Italy, water supply and sewerage have traditionally been managed by municipal public enterprises without legal personality. It is only since 1990 that law has authorised municipalities to establish separate public enterprises ("*municipalizzate*"), and only larger cities in the north of the country have used this possibility. In 1994, a new law provided for the integrated organisation of the water sector in specialised constituencies designed to meet the needs of water management: "*ambiti territoriali ottimali*" (ATO) (optimal territorial areas) with a single authority, based on inter-municipal cooperation, which has to outsource the service to an operator under its supervision for the whole area. The ATO authority may outsource the service to private companies. In practice the public sector continues to prevail.

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<sup>2</sup> Wollmann, H. / Marcou, G. (eds) (2010), *The Provision of Public Services in Europe. Between State, Local Government and Market*, Cheltenham, Edward Elgar.

<sup>3</sup> More details are in the CoE expertise of the draft Law on the National Regulator, DPA/LEX 10/2008, September 2008.

## 2) The concessionary model

In this model, the municipality is in charge of the water and sewerage services, but is not entitled to operate them directly. It may outsource the services to a private company on the basis of a concession or lend-lease contract under its supervision. This system has been developed especially in France from the 19<sup>th</sup> century onwards on the basis of the competence given to municipalities from the time of the French Revolution to provide water. Over time several variants of contracts have developed and they are nowadays known as "*delegations de service public*". Such delegations are based on an administrative contract. Nevertheless, this system is not exclusive, and municipalities may prefer to operate the water and sewerage services directly, or through a municipal public corporation.

At present water supply for 80% of the population is performed on the basis of these "delegation contracts", but only for 50% for sewerage services. Among "delegation contracts", the lend-lease contract is currently preferred to the concession contract in 85% of the cases. The involvement of the private sector in the infrastructure and in the operation of water and sewerage services has resulted in a strong and relatively concentrated industrial sector (with three firms for 88% of the contracts).

In the last past years, a new tendency has been observed. Several major or average-sized cities (in particular Paris, Bordeaux, Rouen) decided to take control of the water supply when the previous "delegation contracts" expired. The major argument usually used is greater control of the costs and saving money on private management.

## 3) The centralised regulation model

This model is typical for the UK. It is the only country in Europe where local authorities have almost completely lost their traditional competence for water and sewage. This is the result of the creation of Water Authorities after the Second World War. These Water Authorities were removed when water supply and sewerage were privatised. However there was no liberalisation of the sector; this demonstrates that privatisation and liberalisation do not necessarily coincide. According to the Water Act 2003, the operators for the water supply and sewerage are "appointed" for a given area by the Water Service Regulation Authority. The company appointed for a given service is subject to very strict obligations under the supervision of the national regulator. The national regulator determines the tariff framework

that the operator must comply with. This is not a competitive model, although introducing more competition in the system is now being contemplated, at least for industrial users.

### *C) Inconsistencies in the water supply and sewerage system in Ukraine*

The present organisation of the water supply and sewerage system in Ukraine uses several of the basic elements of the reference models as summarised above. In principle, there is nothing wrong in trying to set up an organisation based on elements borrowed from different systems with the purpose of finding adequate solutions. But the mix should nevertheless be consistent. The problem with the present Ukrainian system resides in its inconsistencies.

As explained in the Road Map document, responsibility for water supply and sewerage systems was devolved upon local communities, whereas most of them are too small and do not have the capacity to deal with such services that, additionally, were taken out of the inter-budgetary relations and are supposed to be funded only from local resources.

Nevertheless, for historical reasons and as a legacy from the Soviet period, there still exist a number of large local water enterprises that can serve a wide territory. Such cases can be found in urbanised areas with industrial activities. A good example is Water of Donbas, a company of the Donetsk oblast council, deserving 179 ATUs. This is an example corresponding to the local public sector model, with the additional complication that, before the establishment of the national regulators, tariffs had to be approved by each municipality where it operated.

Then, in order to promote private capital investment, the law provided for concession and lend-lease contracts signed by municipalities with companies. This option is especially relevant for densely populated areas where companies may expect a good return. In practice it is an alternative to the local public sector model in these areas.

Lastly, the establishment and the powers of the National Regulating Commission for Communal Services (NRCCS) are typical of the centralised regulation system. According to the law, the national regulator has authority to issue licenses for water supply and sewerage systems, to determine technological norms (water losses, water quality), and to oversee tariffs. However, the national regulator is competent only for water utilities serving more than 100,000 inhabitants, or with overlapping oblast boundaries, or operating with foreign investments. As a result, local authorities that could have the capacity to regulate these services owing to their size are deprived of most of their powers on water supply and

sewerage, whereas smaller local communities which do not have the capacity to run these services remain competent.

The proposal to extend the scope of the competence of the national regulator will only worsen the inconsistency, since at the same time it is proposed to establish joint authorities for aggregated ATUs, e.g. at a level where they will be able to develop the technical and economic capacity that is required. This means that the new institutional arrangement would result in the creation of authorities with only minor powers, since the main powers (licensing, tariffs) would be exercised by the national regulator. They could therefore appoint the operator, but would not have the power to negotiate tariffs.

Another consequence is that the private sector's involvement is unclear. It is not known who will have the authority to turn to the private sector, for what kind of service and under which kind of contract (concession / lend-lease contracts or procurement, engineering contracts...): the national regulator, through the exercise of its powers or the new joint authorities that are now contemplated? Additionally; it is not clear whether the national regulator is an agent of the Government or an independent regulatory authority, and yet its decisions might have impact on the conditions under which private investors, in particular foreign ones, could commit themselves in the development of this sector. The issue here is not the option, but the clarity of the option.

To sum up, the current system is characterised by several weaknesses: inconsistencies in the regulatory framework, overregulation owing to the addition of several regulatory levels, unnecessary centralisation in larger communities and unjustified decentralisation in smaller communities, uncertainties in the public and private sectors involvement in water supply and sewerage.

## **II. Developing the Road Map orientations**

The new Road Map seems to indicate the right direction for overcoming these difficulties: planning and inter-municipal cooperation. But, it should probably be supported by other measures.

### *A) Water areas*

Inter-municipal cooperation might be a good way for organising responsibility for water supply and sewerage at an adequate level while safeguarding the competence of local self-government bodies. But, this cooperation cannot be left to voluntary agreements between local communities supported by central government incentives. Water management requires consideration of the geological and geographical constraints. The design of the water areas has to be based on scientific data, not on political arrangements. This is important both for the water resource management and for the network design.

Planning areas might be distinct from supply areas, since planning areas have to take in to account water basins. Planning has to regulate the various and competing uses of water resources and protect them against developments that could affect them negatively, in particular urban developments. France has developed over time a water resource planning system with two planning levels that has served as a model for EU directives: a guidance scheme for water planning and management at the level of the water basins, and a water planning and management scheme for each sub-basin. The scope of these planning documents was recently strengthened by a law of 12 July 2010. The strategic urban planning documents in particular have to comply with the basic orientations of the guidance scheme and with the objectives of the water planning and management schemes concerning the preservation of water resources and the cost sharing between categories of users. In France different authorities are responsible for water resource management and for water supply networks.

The scheme that is sketched in the Road Map seems closer to the Italian system. There should be an authority for each water area and this authority should be set up on the basis of an inter-municipal cooperation agreement. The authority should be competent for water management, supply and treatment. This would probably not allow for the avoidance of wider planning schemes, since water area authorities could not realistically reflect the pattern of water basins in Ukraine, but they could at least take over the lower level of water resource management. Then, water area authorities should appoint one or several operator(s) to operate the networks (water supply and sewerage).

#### *B) Public and private*

It will be necessary to clarify the role of the private sector and of the public sector. As we have seen, in European countries the municipal public sector has a very strong position in the field of water supply and sewerage, and there is a tendency to turn back to the public

sector. However, the case of Ukraine is more complex because of the huge amount of capital investment needed in the infrastructure. If the Government policy is to rely more on the public sector, public enterprises will have to borrow to finance investments, and this will probably increase the public sector debt. If concession agreements are used, it is for the contractor to borrow, who will then recover the costs on the fees.

This shifts the question of the acceptability of higher fees for water supply and sewerage. Furthermore, less populated areas are unlikely to attract private investors, because of lower rates of return. As a result, a mix of solutions would be probably necessary: municipal public enterprises, concessionary contracts of different types with different risk and cost sharing arrangements.

### *C) Regulation*

But there is no need for a national regulator with such structures. Water area authorities will be specialised structures able to recruit the necessary staff for assessing the capacity of enterprises, for negotiating with them and for setting tariffs. There are good reasons, particularly for water, to have tariffs based on local production and network costs. There are water resources everywhere but with different production costs. Local tariff decision-making will increase the opportunity for having tariffs reflect the costs. At the national level water-tariff setting will result in uniform tariffs or only grossly differentiated tariffs according to large regions. This can be justified with equity arguments but, on the other hand, this will hide situations of unjustified profitability for some regions, while others will hardly be able to cover the costs, and as a whole the management will be less transparent. What is needed is a harmonisation of the parameters for calculating costs and tariffs upon which contracts should be based. But, this task is typical of the ministry, and does not require a national regulator.

If the disparities in water tariffs increase over time, this could give rise to the need for a national water equalisation fund, with budgetary resources or a small tax on operators. Equalisation would have to take into account efficiency indicators, but the advantage would be that the cost differences would appear more clearly.

Furthermore, if the water area authorities were well equipped, licensing would become useless because these authorities would be able to assess the capacities of private companies applying to a tender.

Other tasks of the present national regulator, such as rule-making, publication of standards, quality control, supervision of water area authorities, benchmarking, do not require the national regulator type of institution; this work is typical of a ministerial department and its territorial branches.

As a whole, the national regulator is unnecessary in this sector and within the existing structure in Ukraine. There is no example of a national regulator for water supply and sewerage in a water system where responsibility lies with the local governments, be it with a strong private sector involvement as in France, or a strong municipal public sector as in Germany. Again, in the UK, there is a national regulator, but local authorities have lost almost all powers in these sectors and there is a direct relationship between the national regulator and the operators.

#### *D) Decentralisation*

The Road Map provides a definition of decentralisation. According to the authors of the document, "*Decentralisation is the transfer of authority and responsibility for public functions from the central government to intermediate and local governments or quasi-independent government organisations and/or the private sector*". This definition is not necessary for the purpose of the Road Map yet it provides an insight of the conceptual framework within which this reform - and possibly other - is conducted. Without giving this statement an importance it may not have, it should however be stated that it is flawed in many respects and cannot be accepted as it stands. Decentralisation is a process that involves the apportionment of powers and responsibilities between tiers of government in a democratic society. The core principles of an effective and democratic decentralisation are to be found in - and must comply with - the European Charter of Local Self-Government. Decentralisation has nothing to do with the transfer of functions to "quasi-independent government organisations" or "the private sector". Decentralisation and privatisation are totally independent and transfer of functions to private entities established at local level is definitely not "decentralisation". Similar statements should be avoided in order not to convey the false - and ultimately unacceptable - message that transferring state functions to private companies operating at local level is a way of implementing "decentralisation" of powers between tiers of government.