



# **Sustainable cost recovery for inclusive and sustainable services: A shared responsibility**

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**SWIM-SM / EIB / MeSHIP PPIF Training Workshop – Strengthening Public Sector Capacity to Mobilize Depollution Investments and Private Sector Participation**  
**Luxembourg 3 July 2013**



# The Challenge :

## Financing inclusive **AND** sustainable services

- W&WW Services – Increased coverage BUT declining service quality :
  - The right to water is effective only if services are inclusive AND sustainable (good service quality, long-lived) → require funding to **maintain** infrastructure
  - Also need funding for infrastructure upgrading and asset replacement
  
- Water Resources – Need to invest in protection, management and secure access to WR:
  - Competition for water resources: efficiency and WDM won't be sufficient
  - Expanding urban areas menace local water sources → can society afford “free sewerage”?
  - And who will pay for adaptation to climate change?
  
- Financing and cost recovery – The sobering reality:
  - Revenues do not cover recurrent costs
  - Vicious cycle of underfunding, underinvestment and poor services
  - Little funding for resilience of infrastructure and protection of resources

# Funding sources limited by different constraints



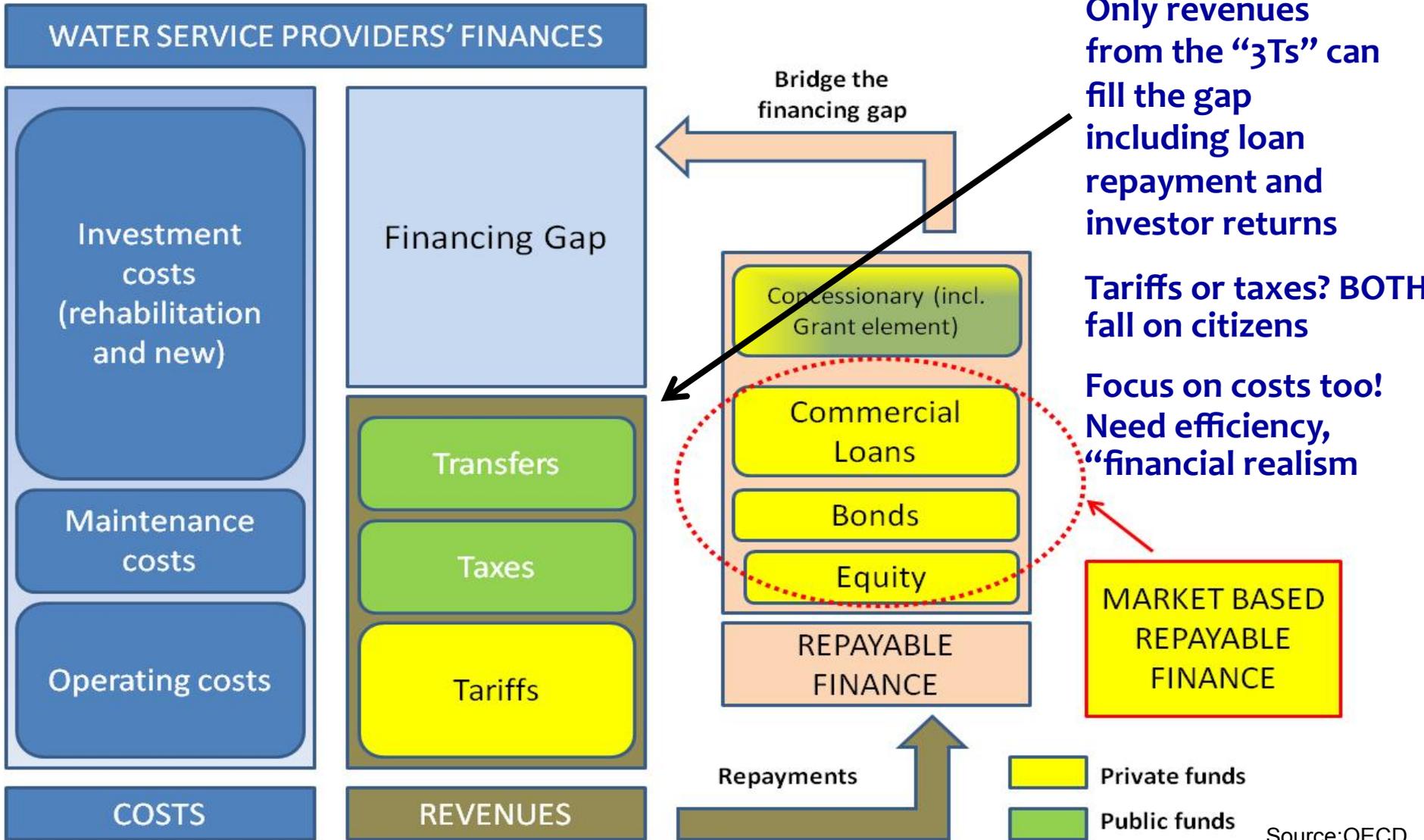
- Public funds (grant/subsidy transfers ): ➡ limited by competing sector demands, lack of sector prioritisation, ad-hoc decisions concerning transfers
- Own/ user sources (tariffs): ➡ limited by poor cost recovery, politicised tariff setting, affordability constraints
- Debt finance (incl. bonds) ➡ limited by sector and operational risk, its cost depends also on reliability of revenues for promoter
- Other (e.g. PPP, equity) ➡ limited by sector and operational risk; can be complex and expensive



**No single source is large enough to fill the financing gap!**

# Financing W&WW services

## Who really pays and how we can all pay less





# **Sustainable Cost Recovery:**

## ***Definition and building blocks***

# || Sustainable Cost Recovery (SCR)



- ❖ An appropriate mix of tariffs, taxes and transfers that:
  - ❖ finance capital and recurrent costs in the long run
  - ❖ leverage other forms of finance (equity, loans, bonds)
- ❖ Tariff policies that :
  - ❖ are affordable to all users, including the poorest
  - ❖ ensure the financial sustainability of service providers
  - ❖ provide appropriate incentives (consumption, efficiency)
- ❖ Subsidy policies that :
  - ❖ are predictable and reliable to facilitate investment planning
  - ❖ meet social and environmental objectives(targeted, non-distortive)
  - ❖ are affordable to national/local governments

**SCR : *not just about full recovery from tariffs***  
***BUT not a “blank check”..***



# “Mixing the 3Ts”:

## They provide differing incentives

- ❖ **Different economic incentives for final users:**
  - ❖ Only tariffs signal the value of water resource and W&S services
  - ❖ Subsidies may lead to over-consumption and over-capacity
  
- ❖ **Different managerial incentives for service providers:**
  - ❖ Raising revenue through tariffs may give stronger incentives to be efficient and increase accountability to customers
  - ❖ Relying on Transfers or Tax-based subsidies may focus on maximizing grant capture instead of efficient investment planning
  
- ❖ **Different incentives for investors and financiers, who:**
  - ❖ Require revenue streams that are sufficient and stable
  - ❖ Prefer revenue streams controlled by service providers not politicians

**Excessive reliance on Transfers and Taxes tends to reduce incentives for overall efficiency**

# || “Mixing the 3Ts”: They entail different risks



- **Tariffs:**
  - Tariff increases may be difficult politically, especially if not linked with good quality and efficient services and if not carefully communicated (perception matters!)
  - Impacts of tariffs on demand may create revenue risk
- ❖ **Taxes:**
  - ❖ Public sector debt may become fiscally unsustainable
  - ❖ Budget funding may lead to politically-driven influence on management
- ❖ **Transfers:**
  - ❖ Grants availability is not predictable
  - ❖ Risk of losing grants e.g. procurement problems, implementation delays
  - ❖ Risk of overinvesting with inadequate cash or expertise to operate

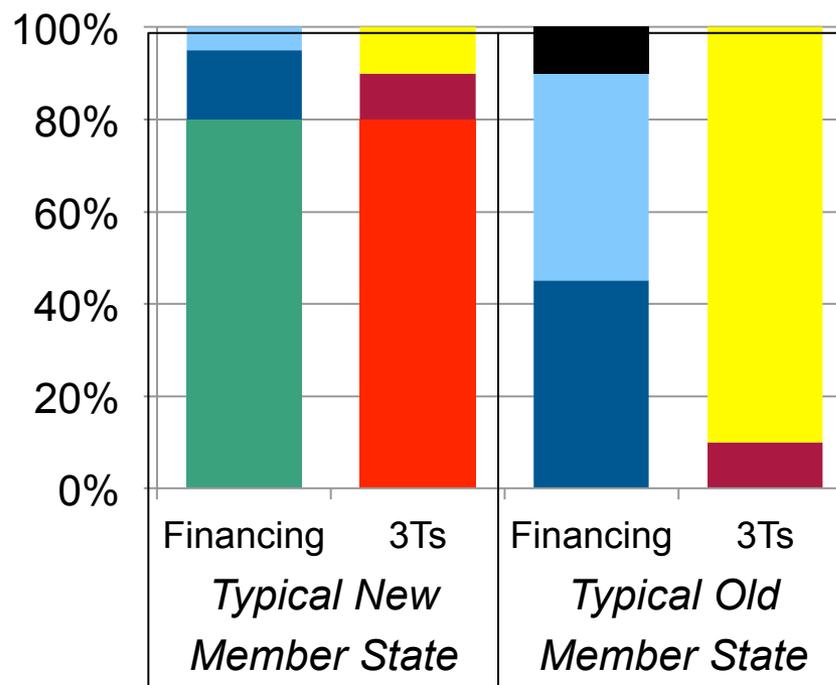
**Lack of financial autonomy brings non-financial risks**

# An Example: Financing W&WW in the EU



- Vast **diversity** of approaches between and even within countries (legal status, governance, structure, etc.)
- No national strategic financial planning, but evolving regulatory frameworks involving different stakeholder dialogues
- In poorer regions, EC Transfers dominate the investment agenda, but mainly focused on compliance not efficiency
- In richer regions, move towards full cost recovery tariffs

- EC grants
- Commercial loans
- EU Transfers
- User Tariffs
- EIB loans
- Own funds
- National Taxes

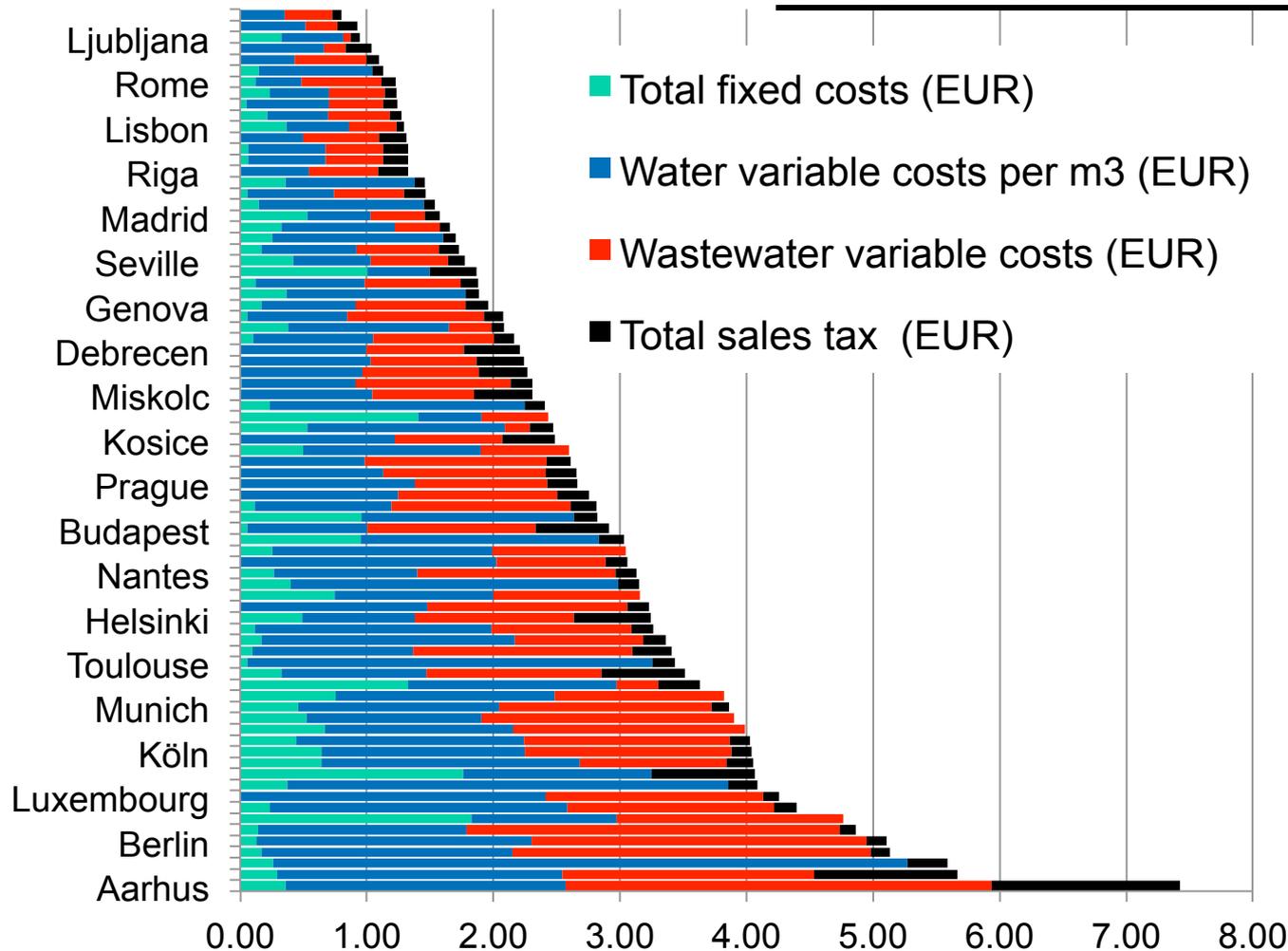


**EU Directives and EC grants drive the sector**



# Tariffs in practice: Examples from Europe

## 2011 Consumer Tariffs (EUR/m<sup>3</sup>)



**Average Tariff**  
**2.6 EUR/m<sup>3</sup>**

**Wastewater**  
**~50% of charges**

**Average Taxes**  
**9% of bill**

**Investment**  
**Subsidies:**  
**0 to 100%**

Source: GWI, EIB



# Building a SCR Strategy

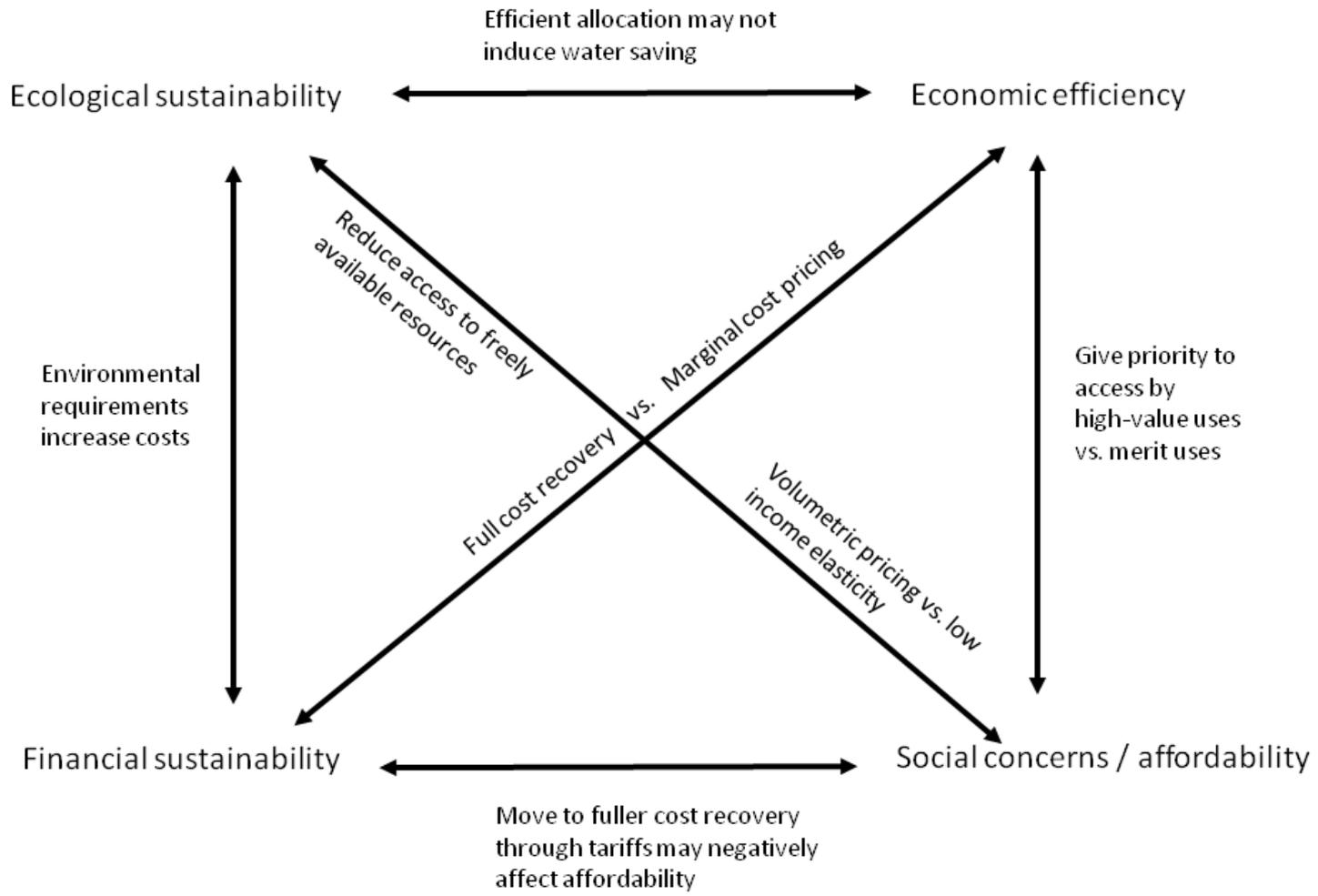
*Policy objectives, policy tools and  
shared responsibilities*

# SCR – The challenges



- There is debate on :
  - Link between value of services, costs and tariffs (why pay)
  - Which costs should be covered through the tariff (how much to pay)
  - How these should be allocated (who should pay)
- Many customers within tariff bands below O&M cost
- Special challenges for sanitation / wastewater services: higher costs, lower willingness to pay or affordability limits already reached
- Address tariff question in isolation instead of looking at broader financial sustainability of providers
- Affordability is often misunderstood or misrepresented even in the EU
- The potential conflicts between financial sustainability and other policy objectives complicate the design and implementation of tariff policies

# Policy objectives, political choice



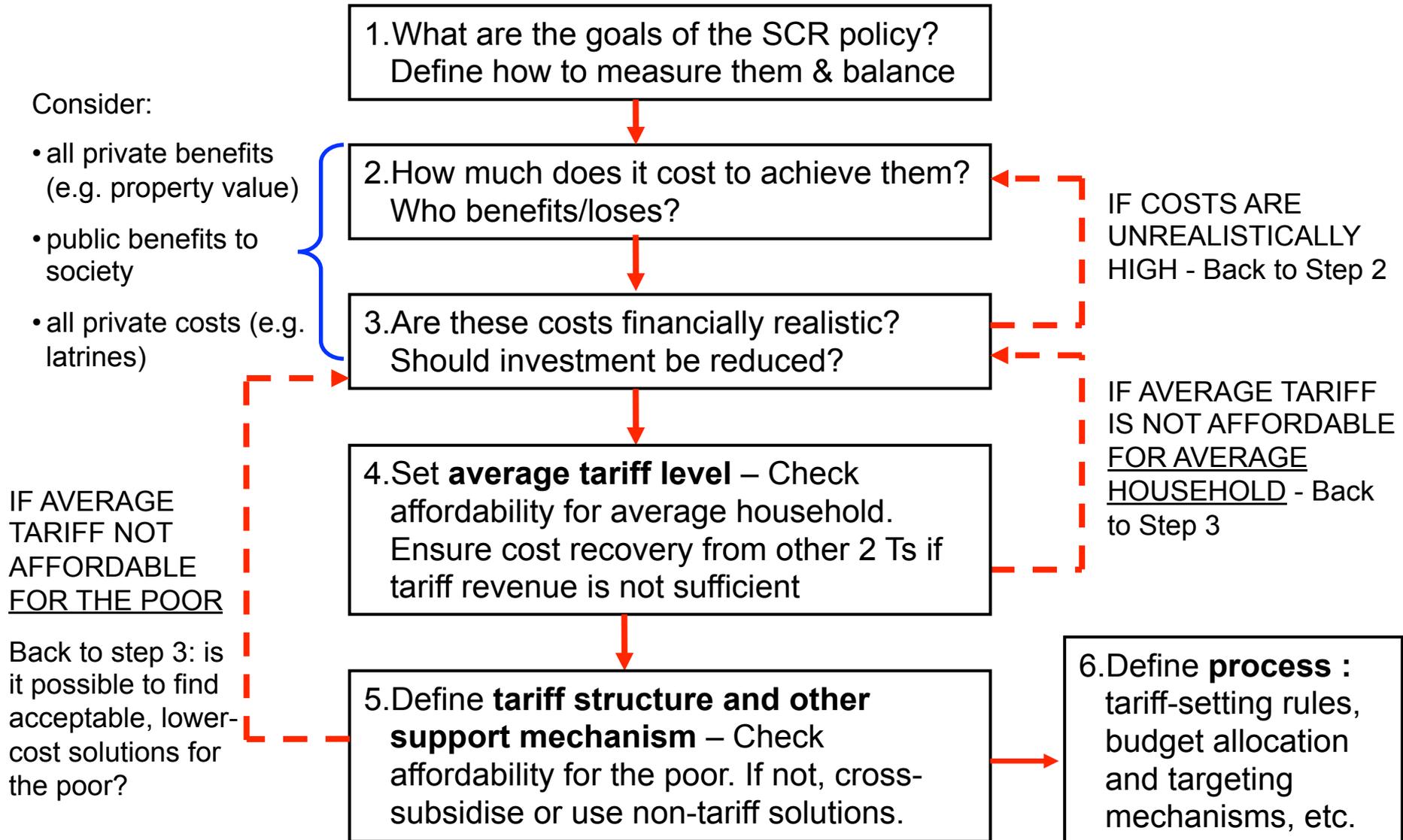
Source: OECD

- *Cannot maximise ALL goals → society needs to choose the balance*
- *But CAN find solutions if understand tradeoffs between goals*



# Designing a SCR strategy :

## A structured approach to decision making



# || Affordability: Getting it right



- ❖ Average tariff levels : affordability for average household → 4 options:
  - ❖ Increase revenue collection (should always be the first option)
  - ❖ Reduce underlying costs – revise investment plans
  - ❖ Cross-subsidize households from non-domestic users or charges on beneficiaries outside the area
  - ❖ Increase revenue from other Ts – revise the target tariff level
- ❖ Tariff structures : affordability for vulnerable groups → first define :
  - ❖ Which population groups are “poor” or “vulnerable”
  - ❖ What is the acceptable “affordability threshold” for them
- ❖ If average bill is not affordable for the poor :
  - ❖ Reduce costs of services provided to the poor (only if acceptable)
  - ❖ Tariff structure with cross-subsidization from other customers
  - ❖ Subsidize access rather than consumptions BUT support poor households through non-tariff schemes



# Making it happen: A shared responsibility

- **Policy-makers** – *Stable rules, clear responsibilities, realistic goals and coherent SCR strategy → They control :*
  - Directly tariffs and tax-based subsidies
  - Indirectly grant predictability & effectiveness via donor dialogue
- **Service Providers** – *Improved planning, efficiency, skills :*
  - Develop investment pipelines that systematically consider wider sustainability issues and involve relevant stakeholders
  - Improve implementation capacity, operational efficiency, commercial management / financial discipline
  - Strengthen dialogue with: (i) policy-makers to justify subsidies and tariff increases, (ii) clients on service quality and acceptable tariffs
- **FIs** – *Stable, targeted grants. Improved support for SCR:*
  - Reduce erratic nature of grant funding and target them carefully
  - Adapt to evolving sector reality with appropriate financial instruments
  - Support structured, step-wise approach to financial sustainability
- ***Citizens*** – *Focus on service quality, efficiency rather than tariffs...*

# Key Messages



- No effective right to water and environmental protection without sustainable cost recovery
- An appropriate “3T MIX” is key (different incentives, risks)
- Availability of budget funding and grants is limited → Tariffs need to be brought to sustainable levels, but need careful design
- Focus on affordability for the poor and assess it locally:
  - Average tariffs that are too low may harm mostly the poor
  - Subsidies: Target the right people, avoid distortions
- Keep costs down - refocus on realistic investment and efficiency
- Achieving SCR is a shared responsibility:
  - Financial sustainability is a political choice, communication is crucial
  - Tariffs should be consistent with quality of service and no inefficiencies should be passed on to customer
  - Financiers need to become a more reliable and effective partner
  - Citizens should focus on service quality, efficiency, sustainability



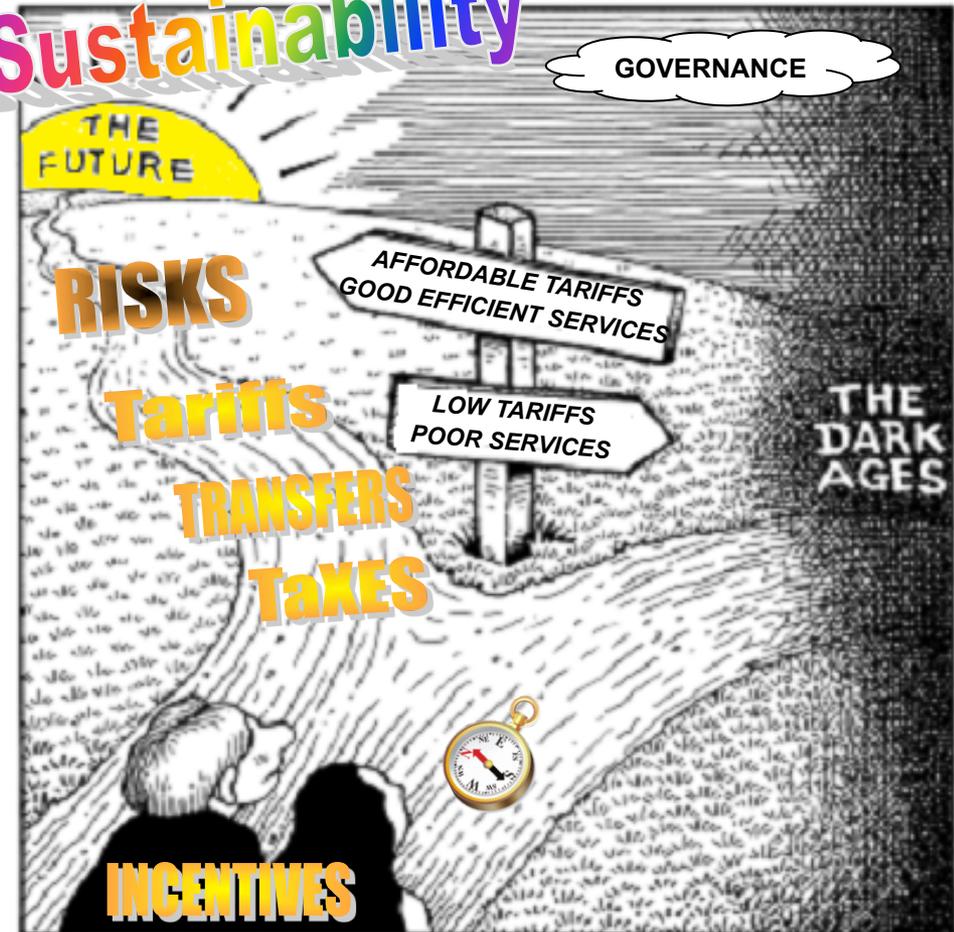
# And remember...



Sustainable cost recovery and the 3Ts are just part of the policy toolkit, alongside:

- **G**overnance
- **R**isk analysis
- **I**ncentives for efficiency
- **P**erformance tracking

## Sustainability





**Thank you for your attention!**



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# Policy-makers' Role:

## Clear rules, realistic goals, appropriate tools

- ❖ **Set up adequate framework:** Stable policy & regulation; institutions with clear responsibilities; coordination of national, local actors (multi-level governance) and “outside water box”, i.e. with strategies for food, energy..
- ❖ **Consolidate industry structure:** decentralisation / regionalisation have impacts on access to & cost of funding - avoid fragmentation
- ❖ **Design realistic investment programmes:** Based on long-term strategy; achievable targets; contain sustainable, financeable projects (not just push for new construction)
- ❖ **Define a clear SCR strategy:** Policy-makers have control
  - ❖ Direct on 2 of the 3 T's (tariffs, tax-based subsidies), hence they have the greatest responsibility for financially sustainable services
  - ❖ Indirect on grant predictability & effectiveness through donor dialogue

**Political decisions cannot be “outsourced”.**  
**Financial sustainability is a political choice.**



# Service Providers' Role : Improved planning, efficiency, skills

- ❖ **Avoid defining investment in isolation:**
  - ❖ Link investment plans to policy dialogue and involve relevant stakeholders
  - ❖ Develop pipelines that systematically consider wider sustainability issues
  - ❖ Phase improved sector conditions (incl. SCR) and investment
  
- ❖ **Improve implementing and O&M capacity:**
  - ❖ Adopt strategic business planning – basis for dialogue with policy-makers
  - ❖ Strengthen implementation capacity
  - ❖ Increase operational efficiency
  
- ❖ **Improve “financial capacity”, creditworthiness:**
  - ❖ Strengthen commercial management / financial discipline
  - ❖ Strengthen dialogue :
    - ❖ with policy-makers on SCR, to justify subsidies and tariff increases
    - ❖ with clients on service quality and acceptability of tariffs

**Tariffs should be consistent with quality of service.  
No inefficiencies should be passed on to customers.**



## DP / FI Role:

# Stable, targeted grants. Improved support

- ❖ **Increase access to funding at affordable cost..**
  - ❖ Reduce erratic nature of grant funding
  - ❖ Blend grants/loans for affordable financing package
  - ❖ Help change perception of sector's risk/return profile (incl. through guarantees)
- ❖ **.. but target grants as funds are limited**
  - ❖ Focus on activities that MAX leveraging - e.g. mainstream project preparation facilities (JASPERS, FEMIP, NIF, WBIF..) and reduce their transaction costs
  - ❖ Adapt to evolving reality (e.g. decentralised solutions, small-scale providers)
  - ❖ Promote viable innovation (incl. financial), scale it up, reduce its transaction costs
- ❖ **Support structured approach to financial sustainability**
  - ❖ Support political dialogue on broader SCR policies, not just “tariff studies”
  - ❖ Require and support transparency of budget allocations
  - ❖ Revise practice based on “old adages”, e.g. increasing block tariffs if access is low
  - ❖ Provide innovative, effective ways to deliver subsidies to those in need

**Be a more reliable and effective partner.**

**Use grants so that they become unnecessary over time.**



# Case Study - The 3Ts in Portugal

- ❖ **Tax-based subsidies (National Budget)**
  - ❖ Reached limit - no increase expected due to competition with other sectors (health, education, transport, solid waste)
  - ❖ Contradicts user-pays and polluter-pays principles
  - ❖ Many providers in deficit despite high level of subsidies
- ❖ **Transfers**
  - ❖ EU funds: est. ~ 5bn € 1989-2013, > 65% of investment costs
  - ❖ Competition with other countries: no increase expected
- ❖ **Tariffs**
  - ❖ Average 1.45 €/m<sup>3</sup> = 72% of average cost (2.00 €/m<sup>3</sup>) and about 50% of future estimate average cost (2.70 €/m<sup>3</sup>)
  - ❖ Needed to cover O&M and repay loans (EIB >25% of invest. costs)
  - ❖ Affordability: Average bill = 0.76% HH income (¼ of telecom or energy bill), but for some poor HH > 3%

**Tariffs are low and the only T to meet future challenges**



# Impact of Financial Crisis on the Sector

- **2009 World water Forum (Istanbul) High Level Panel**
  - If we don't get more money now, use it better and prepare for the end of the crisis
  - A crisis is the best moment to exploit new opportunities
  - Move the water sector towards a water-efficient sector
  - There is still a large scope for improvement - low hanging fruits and no-regret solutions
  - Act fast but with long term objectives
  
- **Key questions**
  - What options do we have to resolve structural problems?
  - Problems are known, effective solutions exist, but what are the priorities and the political will to support them?



# The Future: Tariffs and Efficiency

- Financial sustainability + Water Law => Requires cost recovery
- Financing => Debt Service => Must increase net cash-flow
- Necessary to increase revenues AND reduce costs
  - Increase revenues: Tariffs are the only T that can be increased
  - Reduce costs: Need phasing of investment and efficiency gains
- Private sector involvement must be driven by efficiency objectives
- 4 Efficiency Dimensions: Governance, Managerial, System, Users
- Advantage of investing in efficiency:
  - 1) Low investment cost and short pay-back period
  - 2) Water use efficiency => can phase investment and consumers can better manage their bill
  - 3) Consumers should not be charged for providers' inefficiency
    - Currently NRW is 40% if reduced to 20% savings > 200 M €/year

**Tariffs will remain affordable for the majority of the population, but some households may need support**