

Municipal water and waste-water services

Summary of the Operation Performance Evaluation Review

THE PROJECT

This project is one of the first private concessions for municipal water and wastewater services in this eastern European country. It is the culmination of the Bank's work with the capital's municipality (the "municipality") to develop a water and wastewater concession project. The aim of the operation was to enable the municipal water and wastewater company (the "company") to carry out a programme of capital investment in order to fulfil its obligations as the concessionaire of the municipality's water and wastewater system. The investments, estimated at €130-140 million over the first 15 years of the 25-year concession, would improve water and wastewater services and prevent the system from further deteriorating.

At the preparatory stage, municipal risk was largely uncharted territory for the Bank, and the creditworthiness of the municipality was a key concern. This project was the Bank's first successful concession project in the country, and remains the country's only privatised water and wastewater utility.

The Company began negotiations with two western water companies in the mid-1990s. **The two competing companies** each sought a sole-source contract. This prompted the municipality to devise an open, transparent and competitive tendering process. The municipality approached the EBRD to help develop a water and wastewater concession project for public tendering that would serve as a demonstration project for other water companies. The municipal and national governments, with input from the Bank, decided to pursue a concession approach, including both water and wastewater systems.¹ Further unbundling and part-privatisation might have been possible (for example, separating water and wastewater) but the resulting structure is manageable. The concessionaire is free to further subcontract, or outsource, various services to increase efficiency. The concession effectively ties the municipality and the concessionaire to this structure for the next 25 years. This provides stability for the municipality, but limits further privatisation.

PROJECT RATIONALE

The water supply system was neglected during the communist era, mainly due to funding constraints. This lack of funds hampered both operations and maintenance work and also new investments to replace or expand the network. The most urgent works included: rehabilitating the water mains to reduce bursts and leakage, completing a water treatment plant, improving chlorination stations, rehabilitating service reservoirs, installing pressure reducing valves, replacing service meters, installing zonal meters and extending the service network to specified un-served and underserved communities within the municipality.

The municipality was able to arrange for external donor financing to upgrade both the water supply and wastewater systems. However, the overall system was loss making,

¹ Initially the project was only going to involve the water supply system.

tariff rates needed to be increased and staff reduced and it was felt that the private sector could better manage these changes.

Key to the success of this project was the fact that the national government was not a partner in the Company and that the Company only had one shareholder, the municipality. The Company remains the cheapest combined water and wastewater utility in the country, even after the recent rate increases.

ACHIEVEMENT OF OBJECTIVES

In this project, there were different stakeholders with competing objectives, and objectives changed at different phases of the project. Normally, the EBRD joins a project at the request of a project sponsor. In this case, the EBRD also contributed to the design of the project, resulting in a much more significant contribution and much greater Bank additionality. It is therefore necessary to look at all objectives from the viewpoints of different key stakeholders. The challenge in designing such a project is to optimise - not necessarily maximise - all stakeholder objectives.

OVERALL ASSESSMENT

Overall, the Bank's operation was rated *Successful*. The Bank's additionality was rated *Verified in all Respects*. The transition impact was rated *Good*. The project's environmental performance was rated *Good*, from the perspective of both the Bank and the water and wastewater services provider. The environmental changes attributable to the investment were rated *Some*. The project complies with the strategies and policies of the Bank, and it succeeds in its aims of attracting additional investment and improving operational performance. Achievement of objectives, the project's financial performance and Bank handling were all rated *Good*.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

The Bank's Project Evaluation Department (PED) rated the short-term transition impact (TI) at the company level as *Excellent*, and the longer-term TI as *Good*, with a *Medium* risk attached to it. This difference in ratings primarily results from the fact that this project was the first of its kind in the country, and all related contractual arrangements are now in place. This means there is less potential for major innovative arrangements in future (apart from certain refinements and adaptations). The medium risk element stems from the political environment, and from whether the sponsors will continue to succeed in imposing a commercial ethos on services that are widely regarded as a natural monopoly that should be publicly controlled.

The environmental performance of the project was rated *Good*. The Bank undertook appropriate due diligence, and the company is committed to the EAP. However, actual environmental improvements are so far limited, and are partly related to activities funded by other donors (JICA, GTZ and the EU).

The extent of environmental change was rated as *Some*. Improvements in the quality of wastewater discharge have reduced the impact on the local river and downstream users. Environmental reporting has improved and there is close collaboration between the company's environmental laboratories and its municipal counterparts.

The EBRD played an instrumental role in assisting the municipality in the design of the project. As a result, PED concluded that additionality was *Verified in All*

Respects.

BANK HANDLING

PED rated overall Bank handling as *Good*. The project would not have happened without the dedication and leadership of the original operation leader (OL) who accumulated significant knowledge and skills throughout the entire process. Unfortunately this accrued knowledge and experience did not filter down to other Bank staff, which led to a considerable corporate brain drain when this OL left the Bank. While the individual achievement is commended, the Bank handled the team aspect poorly in the aftermath. Neither the resident office (RO), nor the environmental department (ED) actively participated in the project preparation site visits. During the project's start up, as problems emerged, the RO did work with the sponsor and the municipality to solve the initial problems and to improve public outreach. The ED is staffed with wastewater specialists who could assist the team in assessing the need for additional improvement works at the wastewater treatment plant (WWTP).

While the project's financial risks were well anticipated in the project design, the technical risks were not. Technical risks include the operational status of the water treatment plant (WTP) and the WWTP, water intake structures, and earthquake planning. The system network upgrades have been more extensive than anticipated, which has had financial implications, and the WWTP was less far advanced than expected, requiring additional investment. While the project was well conceived, and while the team was fully aware of the actions and contributions of other donors, donor collaboration has been limited. The project design assumes continued EU funding for Phase II additions to the WWTP. These funds are potentially in jeopardy. For complex projects that involve multiple donors, maintaining close donor collaboration is critical.

PED believes that the banking team's reliance on a contract management function proved to be insufficient, and that greater emphasis needs to be placed on the regulatory function and approach. While other donors are engaged on this issue, the Bank should keep itself informed as future regulatory changes will have an impact on the project.

MAIN OPER ISSUES AND LESSONS LEARNED

Early engagement leads to long-term success in municipal environmental infrastructure (MEI) projects. The judicious use of TC-funded technical assistance to work with government agencies in preparing projects will result in a more fully developed project concept, and a more successful privatisation for utility services.

There is a need to brand the product even if the utility is a natural monopoly. The new company needs to brand the product to meet changing public perceptions and to promote its new services. Effective public outreach is critical to gain public acceptance, especially when consumers are faced with necessary tariff increases.

The right leadership is key. The project should be structured to give the municipality an opportunity to review staff recommendations for key management positions during the bid selection process.

Monopolistic utility service providers need strong independent regulators. Municipal utility projects require a strong independent regulator to act as an impartial independent body, with clear separation from political institutions, to ensure fair and equitable management of the sector.

Project start-up workshops are necessary. For complex projects, where various parties have different expertise and responsibilities, a project start-up workshop is a good idea.

Employees need to understand their new roles and responsibilities. Unfortunately, the individuals employed in the municipal contract management unit lacked the necessary understanding of western contract law to effectively carry out their contract management function. A start-up workshop might have been an opportunity to ensure that roles and responsibilities were understood and accepted.

There should be closer coordination and collaboration with other donor or MDB parties during the preparation and execution of MEI projects. The EBRD should coordinate more closely with other donors, to both harmonise expectations and to optimise project outcomes. This is especially true in the case of MEI projects that partly depend on capital improvements funded by other donors or IFIs under an OBA scheme.

MEI projects may require two separate evaluations at different stages. Due to the nature of concession-type projects, which are associated with longer maturities, there should be evaluations at two stages. In order to generate and feed back lessons from the preparatory and early implementation stages, a lead time of about two years after Bank investment is considered appropriate. However, for gaining more insights into a maturing concession, a 'second look' evaluation five to seven years after the initial investment would complement the earlier one. If designed in conjunction with the banking team, the initial evaluation could contribute to a mid-course correction in the project. The later evaluation would ensure project accountability. It could take the form of a special study in which a group of similar projects were evaluated.