

# **5** Report on how to adjust current legal provisions and the regulatory framework

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This Chapter provides a legal assessment and opinion of adjustments to the Estonian legal framework in Estonia, which might be required to foster consolidation of water utilities. It was prepared to analyse and give an overview of regulatory provisions to support cooperation between municipalities in the WSS sector of Estonia.

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## 5.1. Background

The Ministry of the Environment of Estonia jointly with other governmental authorities (the Ministry of Finance, the Minister of Public Administration), the European Commission – DG Reform, and the OECD are partnering to enhance the sustainability of water supply and sanitation services in Estonia. The Project will support the preparation of a roadmap for the consolidation of the water utility sector, a requisite for a sustainable and socially acceptable financing strategy and a broader water sector reform in Estonia.

This Chapter provides a legal assessment and opinion of adjustments to the Estonian legal framework in Estonia, which might be required to foster consolidation of water utilities. It was prepared to analyse and give an overview of regulatory provisions to support cooperation between municipalities in the WSS sector of Estonia.

In case of using associations as cooperation vehicles, the following is considered:

- Governance arrangements: how voting rights are allocated among municipalities;
- Conditions required for joining and withdrawing from the association;
- Regime of assets: ownership of assets created under the association and liquidation of an association.

In case of delegation of WSS services provision to a regional service provider the following issues will be described:

- Influence over investment planning and finance;
- How are tariffs set and adjusted across municipalities;
- Monitoring of the performance of the regional service provider;
- Consequences of termination of services by the regional service provider.

As regards the overview of legal and regulatory adjustments to amend licensing of water operators in Estonia, the analysis is divided into three parts:

- Part A: Co-operation between municipalities and/or water undertakings;
- Part B: Delegation to regional service providers;
- Part C: Regulatory questions.

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## 5.2. Conclusions

For provision of WSS services and investing into WSS assets an Estonian commercial association is to be preferred as the legal form of consolidation vehicle. Any municipality or water company may become a member of a commercial association created for the purpose of facilitating co-operation in the WSS sector. In the general meeting of commercial association each member has one vote. Upon withdrawal from such association, the return of the assets to the original holder (leaving member) may be carried through as prescribed in the articles of association or in the members' agreement.

As a way of consolidation, the municipalities and/or the water companies may share functions, or outsource a part of or whole provision of WSS services to a regional service provider. To facilitate the outsourcing, two main alternatives of asset regime shall be considered: (i) ownership of WSS assets remain with the municipality/water company commissioning the services, or (ii) ownership of WSS assets are transferred to the service provider (see below in chapter 7 for details).

Supervision over water undertakings on compliance with the requirements provided by the Public Water Supply and Sewerage Act and legislation established on the basis thereof is fragmented and is being exercised, pursuant to their competence, by the local municipality governments, the Competition Authority and the Environmental Board (see below chapter 8 for details).

Licensing requirement for water undertakings may be a feasible measure to ensure technological, financial and managerial capacities of water undertakings. Depending on the licensing conditions - such requirements may encourage consolidation within the WSS sector, where service providers with incompetent organization and weak economy are gradually directed to merge or otherwise consolidate their business with regional and/or otherwise sustainable water undertakings.

### 5.3. General Background

#### 5.3.1. WSS services providers

In Estonia, the areas where population density and the related pollution load and groundwater protection require that wastewater is collected and treated in order to obtain environmental objectives, are designated as agglomerations (wastewater collection areas). In 2019, the number of agglomerations of more than 2,000 PE (population equivalent) in Estonia was 57, and the number of agglomerations of less than 2,000 PE was 463. According to an analysis commissioned by the Estonian Waterworks Association in 2018 (the “EWA Study”), the vast majority (88%) of the residents live in agglomerations of more than 2,000 PE and only 12% live in agglomerations of less than 2,000 PE.

Provision of WSS services is mainly regulated by Public Water Supply and Sewerage Act (“PWSSA”). As main operating model regulated under to the PWSSA, the WSS services is to be provided by a water undertaking (appointed by local government) who is a legal person, e.g., a limited liability company, a commercial association. The provision of WSS services by a water undertaking is subject to compulsory regulations in the PWSSA (and other legal acts), including approval of the water tariff by the Competition Authority.

If a public water supply and sewerage system is in the ownership of a private legal person, it may make a proposal to the local government to appoint the legal person as a water undertaking. If a public water supply and sewerage system is in the ownership or possession of a local government, the local government shall, independently or in cooperation with other local governments, organise a public procurement procedure for entry into a concession contract for provision of WSS services.

Approximately 80% of the total number of the providers of WSS services in agglomerations are legal persons. Most of the providers of WSS services operating in agglomerations of more than 2,000 PE are water companies owned by the local governments. Besides the water companies, WSS services in Estonia are also provided by the local municipality governments (municipal authority, utilities authority, rural or town/city office).

From the perspective of economic efficiency and sustainability, the current arrangements for WSS provision in Estonia are not sustainable. One of the measures to overcome such situation is further consolidation of water companies/WSS provision.

#### 5.3.2. Voluntary consolidation

According to EWA Study, the representatives of larger, economically more well-off water companies do agree that a regional business would provide a solution for the Estonian WSS sector as a whole, but at the same time, no one has a direct interest in acquiring the small water companies who have facilities in poor condition and depreciated pipes in sparsely populated areas, since the parent company itself would not

directly benefit from this. Rather, it is recognized that in this case the smaller rural area would be subsidised by the more densely populated area.

### **5.3.3. Tariffs**

A water undertaking shall prepare an application to set prices for WSS services and submit it for approval to the Competition Authority before establishing the tariff to be charged from the clients.

According to PWSSA, the recommended principles for calculation of prices for WSS services shall be prepared and disclosed on Competition Authority's website. Under the mentioned principles and current practice of the Competition Authority, the regulated assets do not include assets purchased or constructed using state funds or European Union funds (aid).

The draft of new PWSSA (currently sent to the parliament to go through the legislative process to be passed) explicitly excludes such assets from the regulated assets, i.e. no depreciation costs (amortization) of such assets are allowed to be included in the tariff. There is an exception – some part of depreciation costs of such assets and reasonable return on capital may be included in the tariff, but only to allow a water undertaking to meet its obligations under loans taken for reinvestments (future maintenance) of such WSS infrastructure (to be evaluated by the Competition Authority in each tariff application procedure if needed).

## **5.4. Co-operation Between Municipalities and/or Water Undertakings**

### **5.4.1. Association as a Vehicle for Co-Operation**

As an option for facilitating co-operation in the WSS sector in Estonia, the OECD Secretariat wishes to explore the use of associations as cooperation vehicles. We hereby analyse and give an overview of regulatory provisions connected to associations.

There are two types of associations regulated in Estonia: (i) commercial associations and (ii) non-profit associations. The respective type of association is regulated by Commercial Associations Act ("CAA") and by Non-profit Associations Act.

Pursuant to the CAA a commercial association is a company the purpose of which is to support and promote the economic interests of its members through joint economic activity in which the members participate:

1. as consumers or users of other benefits;
2. as suppliers;
3. through work contribution;
4. through the using of services;
5. in any other similar manner.

A non-profit association is a voluntary association of persons the objective or main activity of which shall not be the earning of income from economic activity. The income of a non-profit association may be used only to achieve the objectives specified in its articles of association. A non-profit association shall not distribute profits among its members.

As the management and decision-making of both types of association are quite similar, there is an important difference with regard to transfer of membership: (i) in a commercial association a member may transfer the membership to another person who becomes a member of the association; (ii) in a non-profit association membership or right to exercise of voting rights of a member cannot be transferred.

Considering the possible activities of consolidation vehicle (provision of WSS services, investing into WSS assets, etc.) a commercial association is to be preferred as the legal form of an association.

Therefore, we focus on description of governance regulations and other rules applicable to a commercial association.

#### 5.4.2. Commercial Association - Commercial Law and Governance Matters

In the below table please find an overview of the main legal aspects of a commercial association regulated by CAA.

**Table 5.1. Selected legal aspects of commercial associations**

Nr.	Issue	Regulation
1	Foundation	An association may be founded by at least two persons. A founder may be a natural person or a legal person. The association shall be entered into the Commercial Register.
2	Articles of association	The articles of association shall set out (not an exhaustive list): 1) the business name and registered office of the association; 2) the purpose of the association; 3) the size and procedure for payment of the contribution; 4) an amount which a member may pay to the association in addition to the contribution, or the procedure for determination of such amount; 5) the procedure for assigning additional duties to members; 6) the control bodies of the association, their competence and term of authority; 7) the beginning and end of the financial year of the association; 8) the procedure for the covering of loss; 9) the procedure for the distribution of assets upon dissolution of the association.
3	Membership	A legal person may become a member of an association.
4	Acceptance into membership	Acceptance of a new member is decided by the Management Board. Upon acceptance into the membership of an association, a member shall pay in contribution (a given amount in EUR, similar to a shareholding). A member may hold more than one contribution. The articles of association may prescribe that the contributions or other payments may be made by non-monetary payment (i.e. transfer of assets).
5	Transfer of membership	Membership may be transferred to another person.
6	Highest management body	General meeting of the members of an association.
7	Management board	Legal representative and day-to-day management body of an association is the management board (consisting of one or several persons).
8	Supervisory Board	An association shall have a supervisory board if the association has more than 200 members or the share capital is greater than 25,000 euros or if so prescribed by the articles of association. The provisions of the Commercial Code concerning the supervisory board of a public limited company correspondingly apply to the competence and activity of the supervisory board unless otherwise provided by law.
9	Dividends	As a main rule, the net profit of an association shall be transferred to the reserves which are not subject to distribution between the members of the association. The articles of association may prescribe that dividends may be paid to the members from net profit or from profit of the previous financial year from which uncovered losses of previous years have been deducted.
10	Liquidation	An association may be dissolved e.g. by a resolution of the general meeting. Upon liquidation, after satisfying or guaranteeing all the creditors' claims and the necessary deposit, the contributions paid by members shall be refunded to the members. The assets remaining after the refund of contributions shall be distributed among the members in proportion to the amount of their contributions pursuant to the asset distribution plan prepared by the liquidators, unless the articles of association prescribe otherwise.

#### *Voting rights*

Pursuant to the CAA, in the general meeting each member of an association has one vote. It means that the number of votes is not connected to a stakeholder's contribution in the association. If "one member – one vote" arrangement proves to be a significant reason preventing larger municipalities to join the association, a regular limited liability company may be considered as cooperation vehicle. In that case larger

municipalities (i.e. municipalities contributing more assets to the company and/or with higher number of clients) could own proportionately larger number of shares and respective voting rights in the company. It should be mentioned that limited liability companies are used as legal bodies for several regional water companies (companies where the shareholders are several local municipalities) already today.

However, the articles of association of some Estonian commercial associations stipulate that the number of votes of a member is in proportion to the nominal value of its contribution, where every 1 (one) euro constitutes one vote. It should be mentioned that such regulation in the articles (as being contrary to the CAA) is not valid and legally applicable in case of a dispute.

### *Joining and withdrawing from the association*

A natural person or a legal person may become a member of an association. The articles of association may prescribe conditions which the members must comply with. Upon acceptance into the membership of an association, the contribution shall be paid unless the articles of association prescribe otherwise. The articles of association may prescribe that the contributions or other payments may be made as non-monetary payment (i.e. transfer of assets).

In general, any municipality or water company may become a member of a commercial association created for the purpose of facilitating co-operation in the WSS sector.

Specific obligations may be imposed on members only pursuant to the procedure provided for in the articles of association.

The management board of an association shall maintain a list of members of the association (similar to a shareholder's list in a company) which shall set out:

1. the residence or registered office and personal identification code or registry code of a member and, if a person does not have Estonian personal identification code, the date, month and year of birth of the person;
2. the amount of the contribution of the member;
3. the size and time of payment of the contributions paid;
4. information on refund of contributions and transfer of membership;
5. the date of acceptance into the membership of the association, leaving or exclusion of members from the association.

A member of an association has the right to withdraw from the association by submitting a written application to the management board. The application shall be submitted at least three months before withdrawal. Upon termination of membership, a member has the right to the refund of the paid contribution.

The right to withdraw may be barred by the articles of association or a contract for up to five (5) years as of acceptance into the membership of the association. The right to leave shall not be completely precluded or made unreasonably complicated.

The articles of association may prescribe that:

- upon termination of membership the contribution is not refunded, but the member shall be paid as compensation the share of the assets which the member would receive if the association were dissolved on the date of the termination of the membership;
- a member of an association shall pay reasonable compensation to the association upon leaving the association if, according to the circumstances, the leaving of the person causes significant damage to the association or may bring about a potential risk to the continuation of the activities of the association.

The association and the members of the association may enter into member's agreement (similar to a shareholder's agreement in a company). It may be prescribed in the articles that upon termination of membership, the member has the right to refund of the paid contribution and compensation as agreed in detail in the members' agreement.

### *Regime of Assets of an Association*

An association is a legal person. Any assets built and/or acquired by the association is the property of the association and in association's ownership (unless leased or otherwise possessed under any other arrangement).

The potential members of the association may transfer WSS assets to the association as non-monetary payments for their contributions (shares) in the association or under contractual arrangements where the ownership passes to the association.

Upon withdrawal from the association, return of the assets to the original holder (leaving member) should be carried through as prescribed in the articles of association or in the members' agreement. A clear set of rules concerning return of assets in case of withdrawal will establish clarity for a member of the association upon use of right to withdraw from the association. A solution upon withdrawal from the association may be as follows:

- The member may (re)acquire any WSS assets it has transferred to the association and/or any assets created by the association that are located in the territory of the member municipality (or in the previous service area of a water undertaking);
- As a general rule, the leaving member may (re)acquire such assets free of charge (except as set out below);
- If the association has outstanding loan obligations connected to the creation of such assets, the leaving member shall compensate the association any such outstanding amounts;
- If such WSS asset is used to provide services to several members, the leaving member shall compensate the association the potential loss or damage resulting from such asset being removed from the possession of the association;
- Any other reasonable technical or financial conditions upon (re)acquiring the assets (e.g. if the assets are created using financial aid, the conditions of the financier must be met).

Upon dissolution of the association, return of the assets to a member may be carried through as prescribed in the articles of association (and/or in the members' agreement). Under the CAA, after satisfying or guaranteeing all the creditors' claims and the necessary deposit, the contributions paid by members shall be refunded to the members. The assets remaining after the refund of contributions shall be distributed among the members in proportion to the amount of their contributions pursuant to the asset distribution plan prepared by the liquidators, unless the articles of association prescribe otherwise.

### **5.4.3. Delegation to Regional Service Providers**

As a way of consolidation, the municipalities and/or the water companies may outsource a part of or whole provision of WSS services to a regional service provider. In such case several questions arise how the WSS assets and services are managed, maintained and financed.

*Overview of the main aspects of an outsourcing arrangement*

**Table 5.2. Selected legal aspects of outsourcing arrangements**

Nr.	Issue	Assets to remain in the ownership of the municipality/water company commissioning the services	Assets to be transferred to the ownership of regional service provider (operator)
1	Underlying legal relationship	Operating (lease) agreement /concession agreement <sup>1</sup>	Ownership through shareholding in the regional service provider and/or operating agreement
2	Maintenance: Financed by:	By operator Operator using tariff revenues	By operator Operator using tariff funds
3	Investments: Financed by:	By operator By municipality / by operator	By operator By operator (or by municipality under a contractual arrangement)
4	Investment planning	Agreement / public water supply and sewerage development plan	Agreement /shareholder's decision / public water supply and sewerage development plan
5	Appointed water undertaking	Operator	Operator
6	Tariffs	To be paid by the client to operator (alternative: to the owner, if the owner is appointed water undertaking)	To be paid by the client to operator
7	Environmental liability	Operator (may be divided with the owner)	Operator

1.Pursuant to PWSSA, if a public water supply and sewerage system is in the ownership of a private legal person, it may make a proposal to the local government to appoint the legal person as a water undertaking. If a public water supply and sewerage system is in the ownership or possession of a local government, the local government shall, independently or in cooperation with other local governments, organise a public procurement procedure for entry into a concession agreement for provision of WSS services.

*Investment planning and financing*

To facilitate the outsourcing, two main alternatives of asset regime shall be considered: (i) ownership of WSS assets remain with the municipality/water company commissioning the services ("Alternative A"), or (ii) ownership of WSS assets are transferred to the service provider ("Alternative B").

**Alternative A financing and decisions**

In case of a regional service provider (operator) is commissioned to provide WSS services, simultaneously the financing model must be agreed. If the owner of the infrastructure is a company, an operating or lease agreement should be entered into between the owner and the operator. If the owner of the infrastructure is a municipality, a concession agreement shall be entered into between the owner and the operator. The daily maintenance should be carried out and financed by the operator.

As a part of the operating agreement, an investment plan or regulation for adopting an investment plan should be agreed upon. Such investment plan should follow as much as possible the relevant public water supply and sewerage development plan adopted by the local municipality. The investment plan should identify the sources of financing, e.g. the owner of the infrastructure shall cover a part of or all investments exceeding certain threshold.

As the only influence of the owner on the investment decisions is exercised through a contractual relationship, the owner shall have the right to participate in the renewal of the investment plan.

As a sub-alternative to Alternative A, only a part of the WSS services may be provided by a third-party service provider (while the owner of the infrastructure remains as the appointed water undertaking). In such case the contractual relationship between the operator and the owner shall include regulation of the maintenance/financing issues.



## Alternative B financing and decisions

In Alternative B the owner of the infrastructure either:

- becomes a shareholder in the operator (if the current shareholders of the operator agree to issue shares to the owner of the infrastructure);
- does not become a shareholder in the operator - the operating and financing of the infrastructure is based on a contractual relationship.

A shareholders' or operating agreement should be entered into between the (previous) owner of the infrastructure and the operator. The daily maintenance should be carried out and financed by the operator.

Similarly, as in Alternative A, an operating or shareholders' agreement shall contain the investment plan (or regulation for adopting an investment plan) which should follow as much as possible the relevant public water supply and sewerage development plan. The investment plan should identify the sources of financing, e.g. the previous owner of the infrastructure/local municipality shall cover part of or all investments exceeding certain threshold.

Depending on whether (the previous) owner of the infrastructure becomes a shareholder in the operator or not, influence of the (previous) owner on the investment decisions is exercised through a contractual relationship and/or through participating in adoption of shareholders' decisions.

## 5.5. Regulatory Questions

### 5.5.1. Monitoring the Performance of the Regional Service Provider

Under the PWSSA Section 15-4 supervision over a water undertaking on compliance with the requirements provided by the PWSSA and legislation established on the basis thereof shall be exercised, pursuant to their competence, by the local municipality governments, the Competition Authority and the Environmental Board.

The supervisory duties between different authorities are divided as follows:

- Competition Authority: Supervision over (i) compliance of the prices for water services and the connection charges with the legislation and compliance with the requirements for establishment thereof as well as compliance of the methodology for calculation of connection charges; (ii) compliance by a water undertaking with the requirements related to accounting and price regulation for water services;
- Environmental Board: Supervision over compliance of the activities of a water undertaking and of a client of a water undertaking with the requirements for handling hazardous substances;
- Local government: Supervision over compliance of the activities of a water undertaking with PWSSA and the legislation of the local government, including (i) local government rules for connection to the public water supply and sewerage system; (ii) local government rules on use of the public water supply and sewerage systems; (iii) local government public water supply and sewerage development plan<sup>1</sup>; and (iv) conditions of services agreements between the clients and water undertaking;
- The Competition Authority shall exercise supplementary supervision on its own initiative, and inspection on the basis of a reasoned request of a local government authority, the Ministry of the Environment or the Environmental Board, over the connection charges and prices for water services.

As an example, local government rules on use of the public water supply and sewerage systems shall be approved by the local government council and it shall include:

1. the procedure for measuring the water to be abstracted and for calculating the waste water;
2. the limit values for pollutants in the waste water and rain water discharged to the public sewerage system such that the waste water discharged from the public sewerage system conforms to the requirements established on the basis of the Water Act and the waste water discharged to the public sewerage system does not damage the functioning of the public sewerage system;
3. the procedure for checking the pollutant content;
4. the procedure for payment for the service of supply of water and sewerage;
5. the definition of water abstracted without authorisation and of waste water, rain water, drainage water and other soil and surface water discharged without authorisation and the procedure for determining the volume and cost thereof;
6. the procedure for interruption and restoration of the supply of water and the reception of waste water and rain water;
7. the procedure for restriction or suspension of supplying water and leading off waste water in the case of damage to or an accident in the public water supply and sewerage system;
8. the minimum permitted limit value of water pressure at the point of connection to the public water supply system depending on the overall height of buildings;
9. the maximum permitted limit value of headwater level at the point of connection to the public sewerage system.

The draft of new PWSSA will confer to the municipalities rights to introduce additional rules for water undertakings on the qualifications of the staff and quality of services.

Another example of the authority of local government is a situation, where the public water supply and sewerage system is in the ownership or possession of a local government. Then the local government shall organise a public procurement procedure for entry into a concession contract for provision of WSS services.

In such case the municipality has the authority to determine the conditions of the tender process. According to PWSSA Section 7 (31) the following information shall be included in the source documents of the public procurement organised for finding a water undertaking:

1. the extent of the licensed territory of the water undertaking and technical description thereof;
2. information concerning the public water supply and sewerage development plan;
3. information concerning the rules for connection to and use of the public water supply and sewerage system;
4. the obligations of the water undertaking;
5. requirements for competence of the water undertaking in order to ensure proper functioning of the public water supply and sewerage system;
6. the terms of provision of the public water supply and sewerage service;
7. the term of the public contract;
8. the investment obligations of the water undertaking in terms of years;
9. the draft public contract to be entered with the water undertaking.

However, as the majority of the public water supply and sewerage systems are in the ownership of a private legal persons (usually owned by the municipalities), the water undertakings will be appointed based on a proposal from the system owner and no tender will be organised.

### **5.5.2. Potential conflict of interests and possible measures to avoid it**

A vast majority of water undertakings are in the ownership of local municipalities. There are municipalities, where the system is owned by the municipality but operated by a legal person belonging to the same municipality. Such conditions may raise questions whether local governments, in using their power to regulate provision of WSS services, use their authority to favour companies in their ownership and whether such regulative power should shift to state entities.

Currently we do not possess direct evidence that such conflict or discrimination exists. Without such direct proof, no recommendation is hereby put forward with regard to potential conflict of interests. At a later stage, should the Estonian government consider a system of licencing water utilities, due diligence on potential conflicts of interest could be considered prior to awarding a licence to operate.

### **5.5.3. Consequences of termination of services by the regional service provider**

In case a water undertaking loses its rights as a water undertaking under PWSSA or wishes to terminate its activities the following will apply<sup>2</sup>.

Pursuant to PWSSA Section 7 (7) termination or suspension of activities of a water undertaking is permitted only if the performance of the obligations of the water undertaking arising from the PWSSA and the contracts entered into with the local government is ensured by another water undertaking appointed by the local government council or if the performance of the obligations of the water undertaking is ensured in another manner and the Competition Authority approves it.

Pursuant to PWSSA Section 7 (6) a water undertaking shall, at least twelve months before suspending or terminating the offering of water services, notify the local government and the Competition Authority in writing of the time schedule for suspension or termination and submit an overview of measures ensuring the performance of the requirements arising from the PWSSA and the contracts entered into with the local government. Similar regulation is proposed to be inserted into the draft of new PWSSA; however the notice of termination is to be filed only with the local government.

The main infrastructure assets of such water undertaking cannot be removed and used in other activities. As organising the provision of WSS services is the obligation of municipalities, then the continuance of the WSS services is to be resolved by the affected municipality. Most likely a water undertaking which is terminating the provision of WSS services will be reorganised an/or its WSS assets be transferred to a (new) service provider.

Pursuant to PWSSA Section 12, in order to use structures necessary for ensuring trouble-free functioning and development of the public water supply and sewerage system, local governments have the right to establish compulsory possession or to acquire, including expropriate, the structure pursuant to the procedure provided in the Acquisition of Immovables in Public Interest Act.

## **5.6. Expanding the Role of the Competition Authority**

The OECD has delivered its Analyses and Action Plan towards Sustainable Water Services in Estonia, which aim is to support the preparation of a roadmap for the consolidation of the water utility sector in Estonia. Chapter 6 reviews aspects of the framework for the economic regulation of WSS services in Estonia, and proposed ways in which that framework could be further developed to assist in the achievement of strategic objectives, including by encouraging efficiency improvements through consolidation in WSS sector.

We hereby analyse and describe which regulatory changes and/or amendments must be carried through in order to implement some of the proposed measures in the subsequent chapters.

### **5.6.1. Price reviews by the Competition Authority and enhancing the incentive arrangements**

In Chapter 6, the OECD makes the following recommendations:

- **Recommendation 1:** The Competition Authority (“CA”) maintains its approach to applying the tariff formula, which allows for companies to raise financeability concerns. It is recommended that the CA provides guidance on the conditions that the CA might expect to be met in order for accelerated depreciation to be allowed for;
- **Recommendation 2:** The CA introduces a periodic approach to price reviews and develops principles which limit the extent to which existing price controls would be ‘re-opened’ as a result of consolidation activity. The use of periodic price reviews could be undertaken in clusters (e.g. regional clusters), and focused on larger companies initially, in order to help manage resource implications;
- **Recommendation 3:** The CA develops a Service Performance Incentive framework (The CA develops, makes publicly available and publicises a KPI framework that provides concise, credible and easy to understand comparisons between companies, using the Portuguese ERSAR approach as a guide);
- **Recommendation 4:** The CA develops incentives that focus on company plans, and planning processes, i.e., the CA develops guidance (i) setting out how it will enable companies that present credible, efficiency-enhancing consolidation plans to share in the benefits they result in, through the treatment of consolidation costs, and commitments concerning how rapidly future efficiency savings will be reflected in allowed prices.; and (ii) setting CA’s expectations with respect to companies being able to demonstrate that robust options appraisal processes have been undertaken in the development of capex plans, and how capex applications will be treated where a company is unable to adequately demonstrate that.

### **5.6.2. Regulatory adjustments needed to broaden role of the Competition Authority**

In order for the Competition Authority to play such scrutiny role within an Estonian context, there would clearly need to be some further development of its competences and capabilities in relation to the tariff approval process, assessment of performance and whether adequate options appraisal process has been undertaken (including possible efficiency-enhancing consolidation plans) (“Assessment Procedure”). To be effective and equal to all parties, it should be clearly regulated how the Assessment Procedure is carried through and what is to be expected from a water undertaking (“Assessment Rules”).

The competence and activities of the Competition Authority are regulated in several legal acts and regulations. Mainly the statute of the Competition Authority and several laws regulating WSS, electricity, heating, gas supply, aviation, railways and competition.

The possible solutions to establish the Assessment Rules are to amend and/or adjust the following legal acts and/or regulations:

- PWSSA: The main underlying rules of water tariff and its approval by the Competition Authority are regulated in the PWSSA. Also, according to the PWSSA, the recommended principles (“Tariff Principles”) for calculation of prices for WSS services shall be prepared and disclosed on Competition Authority’s website. The Competition Authority has disclosed the Tariff Principles.
- In the draft of the new PWSSA the main underlying rules of water tariff are regulated in some greater detail, but the Tariff Principles are continuously to be prepared and disclosed by the Competition Authority.
- If Assessment Procedure and Assessment Rules are to be introduced in Estonia, the most suitable regulation, where to set out the main rationale of Assessment Procedure, is the PWSSA

itself. A priori, it would seem to make sense to set the more technical mechanisms in the regulatory framework to allow some capacity to adjust over time.

- **Tariff Principles.** As pointed out in Chapter 6, an assessment of a specific tariff request by a water company is a complex and challenging task, which must be regulated in reasonable detail to enable water companies to understand and comply with it. Therefore, the detailed Assessment Rules should be prepared by the Competition Authority (undoubtedly having the best expertise in that area) and incorporated into the Tariff Principles, i.e. the Tariff Principles are to be preferred for incorporation of the Assessment Rules.

The following table indicates the most suitable legal act or regulation to be amended in order to incorporate the specific proposals set out in Chapter 6.

**Table 5.3. Suitable acts or regulations to be amended to reflect selected recommendations**

Recommendation No.	Issue	Most suitable legal act or regulation
1	Tariff formula	Tariff Principles
2	Periodic approach to price reviews Principles which limit the extent to which existing price controls would be re-opened and/or formula which provides for prices to be adjusted automatically	PWSSA Tariff Principles
3	Service Performance Incentive framework (KPI framework)	Tariff Principles
4	CA's guidance: (i) on consolidation plans (ii) on assessment of options appraisal processes have been undertaken in the development of capex plans	Tariff Principles

#### *National water strategy (plan)*

As pointed out above, the EWA Study concluded that at least regional WSS business arrangement would provide a somehow sustainable solution for the Estonian WSS sector as a whole.

For the Competition Authority to verify that in a tariff application adequate options appraisal process has been undertaken, it would be highly recommendable that each application could be verified against a national water strategy (or development plan) setting out the desirable principles of consolidation and/or or cost efficiency measures in WSS sector.

Such national strategy can be established through several means. The most suitable form for such strategy document would be a national WSS consolidation plan adopted by the Estonian Government or by the Ministry of Environment. Reference to a national strategy could be made in the legislative framework, even if the strategy itself could be considered a secondary piece legislation. This would allow some flexibility to adjust the strategy to shifting conditions without shattering the legislative framework.

### **5.6.3. Overview of Possible Legal and Regulatory Adjustments for Licensing of Water Operators in Estonia**

In order to enhance monitoring of water undertakings' performance and/or facilitate the consolidation of WSS sector, an obligation to apply for licence (authorization) may be introduced.

Currently, in Estonia no specific licence requirement apply for water undertakings (except for environmental licences to use water resources). Under current regulations of the PWSSA, a water undertaking who is allowed to provide water services within a specific service area will be appointed by the respective local government.

As mentioned above, supervision over compliance with the requirements provided by the PWSSA and legislation established on the basis thereof shall be exercised, by local governments, the Competition Authority and the Environmental Board.

However, in areas of electricity network services, distribution of natural gas and distribution of heating services licencing requirements apply. Applications for licence (authorisation) are processed by the Competition Authority. Supervision of the service provider in the electricity, natural gas and heating sectors is performed by the Competition Authority as well.

As an example, the authorization for the provision of electricity network services through a distribution network is issued to the undertaking if that undertaking fulfils among others the following requirements:

- the organization of the undertaking is suitable considering the extent and nature of the activity applied for;
- the undertaking employs a sufficient number of staff with the necessary qualifications, including persons qualified to perform electrical work and to supervise electrical installations;
- the undertaking possesses commercial prerequisites for operating in the area of activity applied for;
- the undertaking possesses other prerequisites necessary for operating in the corresponding area of activity in accordance with this act and the legislation enacted under it;
- the actions of the undertaking do not jeopardize the security of supply;
- A distribution network operator must have at its disposal the technical, physical, financial and human resources requisite for the preservation and development of the assets required for the provision of network service.

Similarly, a licence requirement could be introduced to water undertakings that provide public water supply and sewerage services and which are appointed as water undertakings by the local government. The responsible authority could be the Competition Authority, which has previous experience of licencing procedures of utilities. The purpose of the licencing requirement may be to ensure that a water undertaking has the technological, financial and managerial capacity to supply water services in accordance with the requirements of legal acts and in compliance with the special conditions of the licensed activity.

As an alternative solution, the PWSSA should set out (i) which requirements a water undertaking must fulfil (broadly in line with requirements applicable to the energy sector); and (ii) that only companies fulfilling such requirements can be appointed as water undertakings (the draft of new PWSSA will confer to the municipalities rights to introduce additional rules for water undertakings on the qualifications of the staff and quality of services).

To allow water undertakings to adapt to such measures and conditions, a transition period of 3-5 years may be reasonable.

The application to obtain licence shall be submitted by the water undertaking. General particulars and documents required for a licence application is regulated by Estonian General Part of the Code of Economic Activities Act. An economic administrative authority (the Competition Authority) adjudicates applications for activity licences by grant of or refusal to grant an activity licence within 30 days after submission of the application. The time limit for adjudication of applications commences from the submission of all the required information.

Revocation (termination) of the licence shall be carried out in accordance with section 37 (Revocation of activity licence) of the Estonian General Part of the Code of Economic Activities Act.

Licensing of water undertakings will create inevitably more procedural burden on the authority to be responsible for issuing the licences (e.g., the Competition Authority). As already mentioned, the draft of new PWSSA will confer to the municipalities rights to introduce specific rules for water undertakings on the

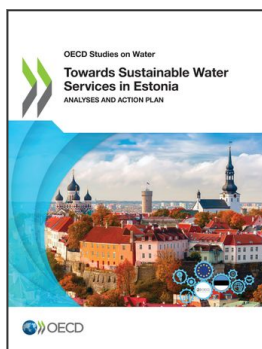
qualifications of the staff and quality of services (i.e., if such conditions are not met, municipality can refuse to appoint the specific company as a water undertaking). The new draft law indicates that the legislator intends to leave the supervisory duties to the municipalities. To introduce an (additional) licencing requirement to be managed by a state authority needs significant reasons.

In conclusion - licencing requirement or additional rules for water undertakings on the qualifications of the staff and quality of services set out in the PWSSA may be a feasible measure to ensure technological, financial and managerial capacities of water undertakings. Depending on the conditions - such requirements may encourage consolidation within the WSS sector, where service providers with incompetent organization and weak economy are gradually directed to merge or otherwise consolidate their business with regional and/or otherwise sustainable water undertakings.

## Notes

<sup>1</sup> As recommended in subsequent Chapters, significant benefits would derive from endowing the Competition Authority with the capacity to challenge development plans, to benchmark their level of ambition and how thoroughly they explore options to enhance efficiency (including through some form of consolidation); see in particular Chapter 6 and the discussion on benchmarking development plans.

<sup>2</sup> These provisions are specified in the draft PWSSA.



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