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# **Modernization with Economic Principles**

## **EUREAU POSITION**

### ***Introduction***

The European Commission has commissioned a study on the introduction of competition to the water services sector.<sup>1</sup> In the White Paper on Services of General Interest, the European Commission has announced that it will take a position on this issue at the end of 2004.<sup>2</sup> The European Parliament has, on two occasions in identical wording, taken the position that water supply, including wastewater disposal, should not be subjected to liberalisation, but should be “modernized with economic principles in accordance with quality and environment standards and the needs of efficiency”.<sup>3</sup> EUREAU, the European federation of the national associations of water services providers in the member states of the European Union and the EFTA, would like to contribute to this debate by indicating what the European Union could do to promote the modernization of its water services.

### ***Modernization of Water Services***

To modernize means to adapt to modern needs, taste or usage.<sup>4</sup> Since the first Environmental Action Plan in 1972 the European Union has issued a dozen of directives relevant for water services. The most important ones are the Drinking Water Directive (1980, revised in 1998), the Urban Waste Water Directive (1991) and the Water Framework Directive (2000). The DWD asks for tap water that is safe to drink. This has caused a wave of investment and innovations in treatment facilities and network improvements. The UWWD asks for the collection and treatment of the wastewater originating from all urban areas. The UWWD has caused an even larger wave of investment and innovations in wastewater treatment plants and sewer improvements than the DWD because of the different starting situation<sup>5</sup>. The WFD asks for bringing all surface and ground waters into a good chemical and ecological condition. The WFD also asks for the introduction of economic instruments in water management, like cost recovery for water services and the consequent application of the polluter pays principle in water management. There can be no doubt that these directives have contributed and will contribute in the future to the modernization of the water services industry. In international comparisons the quality and reliability of the water services of the European Union lead the world ranking list, and consumer surveys show that the European consumers are in general satisfied with the water services provided<sup>6</sup>. Of course there is still some catching up to do in certain areas, especially in

<sup>1</sup> Internal Market Strategy 2003-2006, COM(2003)238, page 14

<sup>2</sup> COM(2004)374, paragraph 4.6

<sup>3</sup> P5\_TA(2004)0018, paragraph 47, on 14-01-2004 and P5\_TA(2004)0183, paragraph 3, on 11-03-2004

<sup>4</sup> Webster's Third New International Dictionary, page 1452

<sup>5</sup> In certain parts of the European Union the investment wave in waste water treatment has started earlier as a consequence of the Bathing Water Directive (1976).

<sup>6</sup> Eurobarometer 58, Consumers' Opinions about Services of General Interest, December 2002

the new member states, but on the whole the water services industry is a modern industry already. That does not mean that there are no challenges left. The new 2004 WHO guidelines ask for more systematic risk management in drinking water supply. Thanks to improved detection the knowledge about residual chemicals in water, like pesticides, pharmaceutical residuals, some of them suspected to be endocrine disruptors, has increased tremendously. These residual chemicals ask for better prevention and better treatment. The water services industry is looking forward to the river basin management plans required by the WFD in 2009 which should address these problems.

### ***Water services and economic principles***

Water networks are the classic example of natural monopolies. It costs less to have one distribution network instead of two or more competing ones in the same area. The costs of water transport are high relative to the production costs. Water networks can be used for a long period of time. This means that in a market system only one network will survive and that this monopoly will not be contested by new entrants. The borders between the different regional monopolies will be determined by the local availability of water sources and treatment and transportation costs. Water services are also very important for public health, so water services should be accessible to all, including the poor and remote areas. This has caused city governments all over Europe, but also in North America and Japan, at the end of the nineteenth century to take control over the water and wastewater services and to organize them according to their history, culture, and political sensitivity. The water services should be developed in order to provide universal access and infrastructure development should precede rather than follow urban development. The most frequent model became the city water supply, run as a department of city government. Another, less frequently used model was the concession, in which the city government licences the water service out to a private contractor but keeps responsibility on important aspects of the water services like tariffs and the quality of service.

These fundamental technical and economic conditions of water services have not changed. Abandoning the (national, regional and local) governmental regulation of water services is therefore no option, as it would bring back the problems of the nineteenth century.

### ***Modern governance of water services***

In the last decades of the previous century the governance of water services, both public and private ones, has been thoroughly modernised. Important developments are:

- Outsourcing of non-core business and the increasing use of modern information and communication technology have increased efficiency. Roughly one-third of the total value added in the water services industry is now done by outside contractors, and the trend is still upwards. The public procurement directives<sup>7</sup> ensure that the competition between these contractors is transparent and non-discriminatory.
- Systematic monitoring, independent verification and knowledge management has increased the knowledge of water quality risks and stimulated research and development.
- Benchmarking has proven to be a good instrument stimulating performance both in terms of quality and of efficiency.

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<sup>7</sup> Directives 2004/17 and 2004/18

There has been a rapid dissemination of modern management techniques among water and wastewater operators:

- The introduction of (total) quality management systems has increased the accountability of water services.
- In the public sector more and more delegated management structures (agencies, incorporation and concentration into multi-authorities co-operations) have been introduced, increasing transparency and accountability
- In the private sector the regulation of private management has been improved. Examples are the introduction of an economic regulator in England and Wales after the privatisation, and new equitable and transparent rules of competition have been introduced in France and Spain for the award of concession and affermage contracts.

The results of all these modernizations in the governance of water services are good. Quality has improved across the board and there are clear indications that the productivity has risen<sup>8</sup>.

### ***What to do?***

In the White Paper on Services of General Interest the European Commission classifies water services into the category of “network industries providing services of general economic interest”<sup>9</sup>. Article 16 of the Treaty establishing the Economic Community, introduced in 1997, says: *(..) given the place occupied by services of general economic interest in the shared values of the Union as well as their role in promoting social and territorial cohesion, the Community and the Member States, each within their respective powers (..), shall take care that such services operate on the basis of principles and conditions which enable them to fulfil their missions*. For some other network industries providing services of general economic interest, like electricity, gas and telecommunication, the European Union has issued sectoral directives on the basis of Article 16. The common elements of these sectoral directives are the unbundling of services into commercial services on one hand and on the other hand services that will remain natural monopolies and should be regulated in order to facilitate competition between the commercial services on the other hand. EUREAU welcomes the conclusion of the European Parliament that such a directive should not be issued for the water services industry because of the different technical and environmental characteristics of water services and the importance of public health. We also note that the Commission Services, DG COMP in particular, have come to same conclusion<sup>10</sup>. It would be only natural if the European Commission should take the same position in its forthcoming assessment of the water sector<sup>11</sup>.

What else could be done to promote the further modernization of the European water services? The primary role should be played by the local and regional authorities in the member states that oversee the water services. The subsidiarity practise has shown to produce good results in the water sector so far. But the European Union could bring some real advantages. EUREAU proposes the following actions:

- Use the Cohesion Fund, which is allocated to the municipalities, to speed up the modernization of the water services in the new member states, whatever the municipalities’ choice of infrastructure operator may be (public or private). Of course cost recovery should be

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<sup>8</sup> See for instance the report submitted by the Dutch government to parliament in February 2005 on the effects of benchmarking in the Dutch drinking water industry. In the period 1997-2003 the drinking water quality has improved, consumers satisfaction remained high, while the increase in costs significantly lagged behind inflation.

<sup>9</sup> SEC(2004)

<sup>10</sup> A. Gee, Competition and the water sector, Competition Policy Newsletter, Number 2 Summer 2004, pp. 38-40

<sup>11</sup> SEC(2004) p. 19

the governing principle, but the backlog of neglected maintenance of the existing assets and the need for new assets is very high and often well beyond the financial means of the users of water services and their governments.

- Stimulate research and development in water services through the European programs, like the Sixth and Seventh Framework Program for Research and Development, ETAP and the technology platform WSSTP.
- Use the Common Implementation Program for the Water Framework Directive to set clear priorities on how to bring the surface and ground waters of Europe into a good condition. More and better treatment is not always the best way to solve this problem, a lot more should be done on prevention, especially on diffuse pollutions. But clear decisions in the river basin programs on what is expected from water service operators and other water users will certainly help to meet those goals in an effective and efficient way.
- Provide legal certainty<sup>12</sup> for the local and regional authorities on how they can set up their water services. The case law of the ECJ on when compensation for public service obligations should be classified as state aid, how and when procurement rules should be applied in the case of public-private partnerships and the issuance of exclusive rights, when a undertaking dominated by a public authority is “in-house” or a third party, is complicated and not easily accessible for local and regional authorities. The conditions imposed by the Cohesion Fund on public-private partnerships in water services are too restrictive and discriminate unduly against public services provided by private operators. There is also uncertainty on the proposed directive on services in the common market for the water services. All these uncertainties hamper decision-making on the most suited governance for the water services and are obstacles for modernisation.
- Set up a program for disseminating best practices and innovations in water services throughout Europe in accordance with the Lisbon Strategy. This could be part of the forthcoming Framework Programme for Competitiveness and Innovation (CIP) that the Enterprise and Industry DG is now preparing for the period 2007-2013<sup>13</sup>. International voluntary benchmarking could be part of this program.

## ***Conclusion***

The European water services have gone through a process of intensive modernization and there is more to come. Due to the technical and environmental characteristics water services should be organised and governed as close as possible to local and regional authorities representing the citizens. In the case of water services the principle of subsidiarity should prevail. Nevertheless the European Union could take some important steps in promoting modernization of water services. EUREAU and its member associations are quite willing to cooperate with the European Commission to develop and implement such a program and contribute in this way to the Lisbon Strategy.

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<sup>12</sup> See for instance the cases Coname (C-231/03) and Parking Brixen (C-458/03) which illustrate how much the interpretation of the EU treaty provisions by the ECJ tends to become highly complex and cannot be seen as an appropriate and definitive solution to clarify the whole “in-house” issue”.

<sup>13</sup> Consultation document on a framework Programme for Competitiveness and Innovation of 10-12-2004.