

Report No. 64412-AL

Decentralization and Service Delivery in Albania: Governance in the Water Sector

A World Bank Issue Brief

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

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Document of
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CURRENCY EQUIVALENTS

Currency Unit = ALL (Albanian Lek)

ALL 1.00 = US\$0.0102859

US\$ 1.00 = ALL 97.2200

WEIGHTS AND MEASURES

The Metric System is used throughout the report

ACRONYMS AND ABBREVIATIONS

ADF	Albanian Development Fund
CGS	Competitive Grant Scheme
DCM	Decree of the Council of Ministers
ECLSG	European Charter of Local Self-Government
EU	European Union
GDWS	General Directorate for Water Supply and Sanitation
GSA	General Stakeholders Assembly
IFI	International Financial Institution
IPA	Instrument for Pre-Accession Assistance
LGPA	Local Governance Program in Albania ³
LGU	Local Government Unit
METE	Ministry of Economy, Trade, and Energy
MoF	Ministry of Finance
MPWT	Ministry of Public Works and Transport
NGO	Non-Governmental Organization
NSDLA	National Strategy for Decentralization and Local Autonomy
PNAP	Policy Note and Action Plan
SC	Supervisory Council
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VAT	Value Added Tax
WRE	Water Regulatory Entity

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PREFACE

Over the past decade, the World Bank has intensified its focus on governance as a key factor accounting for variations in development effectiveness. Through its long-standing engagement in Albania, the World Bank has supported institutional development and governance reforms to help strengthen the capacity of state institutions to deliver public goods and achieve development outcomes more effectively and efficiently. Governance is a key pillar of the Government's National Strategy for Development and Integration for 2007–2013.

The World Bank's seminal report on governance and development (1997) defined governance as "the manner in which power is exercised in the management of a country's economic and social resources for development."¹ The Bank's Strategy on Governance and Anticorruption broadens this definition to "the manner in which public officials and institutions acquire and exercise the authority to shape public policy and provide public goods and services."² The authors of the World Bank Institute's Worldwide Governance Indicators offer a more comprehensive approach:

Governance consists of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them.³

This review of the water sector in Albania draws primarily upon this latter definition, which takes into account the popular legitimacy of state institutions and respect for the law among citizens and government institutions—the "softer" aspects of governance that are essential to understanding how policies are made and implemented in practice and how public resources are used.

The Issue Brief was prepared as a background paper to the World Bank's Country Partnership Strategy for Albania for 2011–2014. This review draws on past analytical work on decentralization in Albania as well as relevant World Bank-financed operations such as the Water Sector Investment Project.

This Issue Brief is based on research and analysis conducted by Mr. Klas Ringskog and Ms. Albania Vuji (World Bank consultants). It has benefited from thorough reviews by Mr. Stephen Karam (Lead Urban Economist), Ms. Karin Shepardson (Program Manager), Ms. Catherine Revels (Lead Water and Sanitation Specialist), and Mr. Arben Bakllamaja (Consultant) in the World Bank.

1 World Bank. 1992. *Governance and Development*. Washington DC: World Bank; World Bank. 1997. *World Development Report 1997: The State in a Changing World*.

2 World Bank. 2007. *Strengthening World Bank Group Engagement on Governance and Anticorruption*.

3 Daniel Kaufman, Aart Kraay, and Pablo Zoido-Lobaton. 1999. *Governance Matters*. World Bank Policy Research Working Paper No. 2196.

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EXECUTIVE SUMMARY

i. In an effort to improve the performance of water supply and wastewater services, the Government has designed reforms on the basis of international best practice. Service provision has been entrusted to local government units to better align incentives and improve local oversight. The Government has opted to organize water utilities as joint-stock companies in order to offer the possibility of improved corporate governance. In addition, the Government has created the Water Regulatory Entity, an independent agency mandated to regulate service quality and prices. Finally, considerable investment funding and annual operating subsidies have supported sector reform.

ii. In spite of these well-intentioned policy decisions, utility performance, although improved in some instances, remains disappointing overall, in part because of excessively complex design and implementation of sector governance arrangements. Albanian water utilities bring piped water to 90 percent of urban households but only 58 percent of rural households. Availability of wastewater collection services is much lower, especially in rural areas. Water service is limited to an average of 11 hours per day. Efficiency is also limited, as a significant share of system input does not generate any revenue, in part because fewer than half of connections are metered. Though the aim of decentralization was to foster responsiveness to citizens' needs and promote better performance, *de facto* implementation has not been able to fully achieve this original intention of devolution. While there is some basis for concerns that local capacity to provide, manage, and monitor services is limited, important gaps remain between the assignment of functional responsibilities and the managerial authority and financial resources needed to carry them out.

iii. There is a need to address water sector governance on several fronts—legal, institutional, economic, administrative, and social—all of which have implications for service performance. The legal framework for water and wastewater services is incomplete, lacking criteria for central government intervention when local government units are unable or unwilling to discharge their duties, and inconsistent, particularly with regard to price-setting authority and the legal status of utilities. From an institutional perspective, the functions of policy setting, service delivery, and regulation are assigned to different institutions and levels of government. While this division of functions is desirable, apparent overlaps remain due in large part to the way in which the relevant laws are interpreted and/or implemented; there are also a few gaps, as the regulatory framework is unfinished. In some cases, the transfer of utilities has not been completed. Some economic and financial instruments of water sector governance are controlled by central government institutions, sometimes without consultation among responsible institutions. The subsidy system in particular needs reforms to support low-income households rather than provide performance disincentives by covering shortfalls in utility operating costs. The administrative management of decentralization could be improved by completing an inventory of water sector assets, implementing business plans and performance agreements to monitor performance (keeping capacity constraints in mind), and developing effective systems of internal control. Support is needed to establish a water demand management system, as the lack of effective enforcement mechanisms and low level of metering encourage

overconsumption and inequitable distribution of water resources. Finally, though there are no civil society organizations with a specific focus on water supply and wastewater, performance in this sector appears to be an area of high public concern. Improved communication is needed to raise the level of public awareness about institutional responsibilities and other important sector issues.

DECENTRALIZATION AND SERVICE DELIVERY IN ALBANIA: GOVERNANCE IN THE WATER SECTOR

- 1. In light of Albania's application for European Union (EU) membership, it is expected that the country will have to adjust its legislation to converge with EU directives and policies in the water sector.** Principal among these are the EU Wastewater Directive 91/271, the EU Drinking Water Directive 98/83/EC, and the EU Water Framework Initiative. Convergence will require a major effort to reform sector legislation, governance, and practices. Service provision has lagged behind domestic expectations and other EU candidate countries. Piped water supply and wastewater house connections are relatively widespread in urban areas, but service is unreliable, intermittent, and inefficient. Coverage is lower in rural areas, particularly for piped sewerage, which is generally not cost-effective in non-urban environments. Service is also unsustainable, with cash operating costs running 25 percent above cash operating revenue. As a result, the Government is forced to subsidize operational costs. Investments in the sector have been financed through about US\$ 45 million per year in grants and loans from donors and international financial institutions (IFIs) and US\$ 15 million per year in EU Instrument for Pre-Accession Assistance (IPA) grants, together with some central government grants.
- 2. Since 1996, in an effort to improve the performance of water supply and wastewater services, successive governments in Albania have designed reforms that include many aspects of best practice from elsewhere in the world.** First, the Government created an independent agency, the Water Regulatory Entity (WRE), with a mandate to regulate the quality and price of services. Second, the Government opted to organize the utilities as joint-stock companies in order to offer the possibility of improved corporate governance. This legal model accords with best practice in a range of benchmark countries such as Chile, Colombia, and Spain. Third, the Government decided to entrust service provision to local government units (LGUs) to better align incentives and improve oversight by local populations. Finally, the Government has supported sector reform by channeling some US\$ 60 million in investment funding annually and some US\$ 16.9 million in annual subsidies to cover operating deficits.
- 3. In spite of these well-intentioned policy decisions, utility performance, despite demonstrating some improvements, has not met envisaged expectations.** One important explanation for slipping sector performance is the poor implementation of sector governance arrangements, as well as an excessively complex and difficult to implement design. This policy note will explore the legal, institutional, economic, administrative, and social (participatory) instruments of sector governance and their implications for service performance. The main focus is on the utilities that the Government wishes to decentralize by transferring urban and rural systems into regional utilities according to their service areas, to achieve economies of scale. In so doing, the Government seeks to introduce the generally accepted best practice in the water supply and sewerage sector: (i) decentralization of services to the lowest level feasible in order to facilitate accountability of service providers; (ii) rational allocation of subsidies; (iii) a transition toward tariffs that recover costs—first operations and maintenance costs, and then investment costs—in an effort to maximize efficiency and sustainability; (iv) targeting of subsidies on the basis of household income; and (v) improved autonomy for service providers so that they may be guided by the long-term interests of consumers rather than short-term political changes. Following an analysis of water supply and wastewater sector organization and

performance, this policy note will make some recommendations for future support to the water and wastewater sector.

Overview of Water Utility Sector Performance

4. There are 58 water and/or wastewater utilities in Albania. Of these, 55 are joint-stock companies and two are public enterprises in the process of being transformed into joint-stock companies. The utilities were previously owned by the Ministry of Economy, but following the issuance of Decree of the Council of Ministers (DCM) No. 660 “On the Transfer of Shares of Water Supply and Wastewater Companies to Local Government Units” in September 2007, all were to be transferred to the LGUs they serve. In practice, all but seven⁴ of the utilities have been transferred and have established new Supervisory Councils (SCs) under their local government owners. The two largest utilities—in the capital Tirana and in Durrës, cities that account for over one-third of the country’s population—have not been transferred effectively because these two municipalities have refused to share ownership with smaller local government units.⁵

5. The performance of Albanian water utilities is poor. In 2009, utilities provided piped water to 90 percent of urban households and 58 percent of rural households, respectively. Wastewater collection is offered to 46 percent of urban households and 2 percent of rural households.⁶ Non-revenue water—the share of system input that does not generate any revenue—is high at 70 percent, in part because only 44 percent of nationwide connections are metered. The number of utility staff per thousand water connections averaged 14 in 2009, well above the EU standard of two per thousand. Continuity of water service remains low at 11 hours per day, and is a recurring source of complaint among end-users (Table 1).

6. Very few utilities today are able to fully cover the costs of operation and maintenance from their internal revenues. In 2009, the sector’s financial working ratio was 1.19, meaning that cash operating costs were 19 percent higher than cash operating revenue. This pressure on cash resources has forced utilities to defer maintenance, causing breakdowns, premature replacement of assets, and avoidable costly service. This situation has compelled the Government to provide subsidies to cover operations costs and utilities’ debt service. Operating subsidies, which amount to US\$ 16.9 million per year, or about one-third of direct operating costs, are distributed on the basis of criteria defined by MOF and MPWT, with few incentives for improved financial and operational performance. The lack of positive cash flow from operations also forces utilities to depend on external assistance and central government allocations to finance investments. External grant and lending agencies have contributed about US\$ 45 million per year toward investments and EU IPA grants another US\$ 15 million per year.

4 The water utilities that have not been transferred effectively include Tirana, Durrës, Elber (in Elbasan), Rubik, Lezhe, Rreshen, and Gjirokaster Rural Company.

5 The Council of Ministers has decreed that the Tirana water supply utility be jointly owned by 3 urban municipalities and 15 rural communes, while that in Durrës would be owned by 5 urban municipalities and 10 rural communes. The two city mayors have expressed concern about not having more direct involvement in the appointment of utility directors, and the scope of service coverage.

6 Data are based on utility reporting to the Performance Monitoring and Benchmarking Unit of the General Directorate for Water Supply and Sanitation (GDWS) and represent only rural communes covered within utility service areas.

Table 1: Albania's Water Sector Performance as Compared to Benchmarks, 2009⁷

Performance Indicator	Albania	Western European Benchmark
Overall coverage of water supply services (%)	79	
Urban areas	90	
Rural areas	58	
Overall coverage of wastewater services (%)	46	
Urban areas	68	
Rural areas	2	
Non-revenue water (%)	70	20
Utility staff (per 1,000 connections)	13.59 ⁷	2
Residual chlorine compliance (% of water samples)	98	100
Duration of water service (hours per day)	11	24
Financial working ratio	1.19	0.50

Source: General Directorate for Water and Sanitation (GDWS) Monitoring and Benchmarking System, 2009; Institute of Public Health Report on water quality testing results for 2007–2010.⁸

7. Intermittent water supply, insufficient water pressure, and unpredictable service remain prominent challenges in the sector. To circumvent ineffective public services, many households have invested in their own water tanks, booster pumps, or private wells. Households with water tanks connect booster pumps to the main water pipe and pump water directly to water tanks, a practice that risks contamination and reduces the pressure in the network for other users. While the Ministry of Health, through its local Public Health Directorates, monitors water quality in the main water systems, it does not monitor quality in the rural communes.

8. A pervasive free-rider problem undermines allocative efficiency and equity in water supply distribution. Low-level metering, at less than 50 percent of connections, combined with extensive illegal tap-ins, causes service costs to be distributed inequitably throughout the system. As one example, the Durrës Water Utility reports some 2,500 illegal connections of which it is aware. Where metering is not in place, billing against average consumption means that high-end users, such as car wash companies, drive up consumption volumes without bearing an equitable share of the costs. This widely recognized reality undermines consumer willingness to pay, which contributes to low collection rates. Weak enforcement mechanisms and the absence of a water demand management system suggest that this situation will persist if not addressed in the near term.

⁷ This figure is an average across all 58 utilities and includes water and wastewater sector staff. A closer investigation reveals that nine of the calculated indicators range from 20 to 80 staff per 1,000 water and wastewater connections, which may indicate inaccuracies in the reported data. If these nine indicators are removed from the calculation, the corrected figure for this indicator is 10.31.

⁸ Company Performance Indicators available online at <http://www.dpuk.gov.al/mat.php?lang=1&idm=80&idr=345> and Aggregate Data at <http://www.dpuk.gov.al/mat.php?lang=1&idm=81&idr=345>, accessed on February 5, 2011.

Governance in the Water Sector

9. Recent studies confirm the link between poor water services and poor governance.⁹

The Global Water Partnership and United Nations Development Programme (UNDP) define water governance as “the range of political, social, economic and administrative systems that are in place to develop and manage water resources, and the delivery of water services, at different levels of society.”¹⁰ Other agencies, including the World Bank, have adopted the same definition. Good governance in the water sector includes the ability to design public policies and institutional frameworks that are socially supported. The effective implementation of such policies requires that key stakeholders be fully involved in their formulation. The stated principles of good water governance follow those of good governance in general, focusing on equity, efficiency, participation, decentralization, integration, transparency, and accountability. To understand how the principles apply in practice, it is necessary to look at the instruments through which they are implemented. These policy instruments are legal, institutional, economic, administrative, technical, and social (participatory). This Issue Brief considers all but the technical instruments.

A. Legal Instruments

A brief overview of the government’s decentralization process

10. The decentralization of functions from central to local government units has created a new foundation for intergovernmental relations in Albania on the basis of broad political agreement. In 1992, at the beginning of the transition, the central government promoted political decentralization through directly elected local government units. In practice, however, central government powers were not devolved, leaving LGUs without real authority to exercise their functions or fiscal authority to generate local revenues. This system did not create incentives for LGUs to act on behalf of their citizens, and LGUs often acted simply as an extension of central government agencies. The status of LGUs developed quickly following Albania’s signing of the European Charter of Local Self-Government (ECLSG) in May 1998 and the approval of the new Constitution. The Constitution defines Albania as a unitary state with two levels of local government: municipalities/communes at the first level, and regions at the second level. The Albanian model of decentralization was further shaped by the National Strategy for Decentralization and Local Autonomy (NSDLA), adopted by the Government in 2000. Implementation of the NSDLA has enjoyed broad cross-party support. The Albanian Parliament adopted Law No. 8652 “On Organization and Functioning of Local Government” (the Organic Law on LGUs) in 2000 as well.

11. The Organic Law on LGUs defines three types of functions for local government units: (i) exclusive/own; (ii) shared/joint; and (iii) delegated (both mandatory and non-mandatory). Water supply and wastewater services belong to the first category, over which local government units have service delivery administrative, and investment authority. According to the Organic Law, LGUs possess the following rights: (i) self-governance; (ii) property ownership; (iii) fiscal autonomy; (iv) economic development; and (v) status as a legal entity. By law, LGUs also have the right to raise funds through borrowing.

⁹ UNDP. 2004. *Water Governance for Poverty Reduction*.

¹⁰ Global Water Partnership 2002. The Global Water Partnership was founded in 1996 by the World Bank, UNDP, and Swedish International Development Agency to foster integrated water resource management and ensure the coordinated development and management of water, land, and related resources. <http://www.gwpforum.org>.

12. The first level of local government is managed by local councils, and by mayors and heads of communes. The Local Government Council is the decision-making and policy-setting body of the local government. Council members from municipalities and communes are elected through party lists for four-year terms, and one member is appointed chairman of the council. Mayors (in municipalities) and heads (in communes) are the executive officials of the local government. They are directly elected in local elections for a four-year term, most recently in February 2007. Albania has 65 municipalities and 304 communes, comprising 12 regions.

13. A region is an administrative-territorial entity that comprises several communes and municipalities of adjacent territory and shared interests. The boundaries of each region are defined by the boundaries of communes and municipalities under its jurisdiction. The Regional Council is the region's representative body, and executive authority is vested in the Chairman and Board of the Regional Council. Regional Council members are selected from the Local Government Councils of the municipalities and communes that make up the region. The number of representatives from each municipality/commune depends on the population of the territorial division. The Chairman and Board of the Regional Council are elected by its members. Albania's Regional Councils are weak. They have non-substantial authorities and, in practice, can only intervene in matters delegated either by the central government or by the first level of local government. The Regional Councils are under review and may be modified. Discussions are focused around two potential models: (i) maintaining the current model as defined by the Constitution; or (ii) switching to directly elected councils.

The legal basis for decentralization in the water supply and wastewater sector

14. Effective July 2000, Article 10 of the Organic Law defines water and wastewater services as a function of local government units. Article 73 of the same law assigns LGUs the exclusive right to set water supply and wastewater service tariffs.¹¹ LGUs have the right to provide these services through various methods, including by creating their own companies/enterprises, individually or jointly with other LGUs, as well as by signing contracts with other public or private operators. In 2006, the Law on Concessions granted LGUs the right to enter into concession agreements.¹²

15. The Organic Law focused on transferring ownership of the utilities to LGUs as the principal mode of decentralization. This law was followed one year later by a Law "On the Transfer of Immovable State Property to Local Government Units."¹³ Early efforts to transfer ownership stressed the transfer of individual utilities to a single LGU and avoided shared ownership. These early transfers were often reversed, until DCM No. 660 of September 2007 specified that all remaining utilities would be transferred in shared ownership to the LGUs they served, with shares allocated on the basis of the population of each LGU within the service area of the water company.

¹¹ The right to set tariffs became effective in law in 2001, though some LGUs have not yet gained this right in practice.

¹² Law No. 9663, dated December 18, 2006, "On Concessions".

¹³ Law No. 8744, dated February 22, 2001, "On the transfer of immovable state property to local government units."

Box 1: Water Sector Decentralization in Albania

Phase One

Law No. 8652, dated July 31, 2000, “On the organization and functioning of local government.”

Law No. 8744, dated February 22, 2001, “On the transfer of immovable state property to local government units.”

Decision No. 550, November 7, 2002, approved a Policy Paper on “Decentralization of Water Supply and Wastewater Services” and measures for its implementation. It details criteria for the transfer of ownership and distribution of property rights. It requires that each transfer to be conducted on a case-by-case basis and the result of negotiations between the central and local government units.

The transfer process began only in February 12, 2004, with the transfer of a number of water and wastewater systems that would serve only one LGU.

DCM No. 81, dated February 12, 2004, transferred the “immovable property” of state-owned companies to a list of selected LGUs. It did not specify whether they were assets or shares. The Decision affected 15 companies/enterprises, of which four were transferred to four LGUs where service areas and jurisdiction matched. The assets of 34 stand-alone water systems were taken from 11 mother companies and transferred to 15 other LGUs.

Decision No. 173 of March 26, 2004, affected nine companies. The Decision transferred three companies to three LGUs with matching service areas and jurisdictions. In addition, the assets of 17 selected stand-alone systems were transferred from eight companies to six LGUs.

Decision No. 809, dated November 26, 2004, affected 19 companies, some of which had already been partially affected by previous Decisions. One company was transferred to one LGU with matching service area and jurisdiction. The assets of 68 selected stand-alone systems were taken from 18 companies and transferred to 18 LGUs.

In March 2005, Law No. 9352 was approved to amend Law No. 8102 “On the regulatory framework of the water and sanitation sector,” to enable LGUs to exercise their right to set tariffs.

Decision No. 711, dated October 18, 2006, transferred one company to a single LGU whose service area and jurisdiction matched. The assets of 18 selected stand-alone systems were transferred to nine LGUs.

Phase Two

DCM No. 660, dated September 12, 2007, “On the transfer of shares of water supply and wastewater companies to local government units.”

DCM No. 677, dated October 3, 2007, “On some amendments to DCM No. 642, dated October 11, 2005, “On supervisory councils of state-owned joint-stock companies.””

DCM No. 678, dated October 3, 2007, “On some amendments to DCM No. 271, dated May 9, 1998 “On the approval of the model statute of state-owned joint-stock companies.””

Guideline No. 965, dated December 11, 2007, “On the transfer of shares of water supply and wastewater joint-stock companies to local government units,” issued by METE.

Source: Ministry of Interior. 2007. “Strategy of Decentralization and Local Government.”

16. The decentralization process can be divided into two phases (Box 1). The first phase, from 2000–2006, resulted in the transfer of assets of 137 stand-alone systems to 12 municipalities and 52 communes, and of five companies and four state enterprises to nine respective LGUs. This phase took a case-by-case approach, as required by Decision No. 550 of 2002. The second phase began with DCM No. 660, dated September 12, 2007, through which the Government decided on the transfer of ownership of all remaining water companies to the respective LGUs, with shares distributed in a manner proportionate to the population of each jointly owned company's service area, and with the creation of new SCs. The water sector's decentralization process, including preparation of relevant secondary legislation, has been managed by an interministerial working group composed of representatives from the Ministry of Public Works and Transport (MPWT), the Ministry of the Interior, Ministry of Finance and the Ministry of Economy, Trade, and Energy (METE).

Shortcomings in the legal framework for water sector decentralization

17. Though the aim of Albania's decentralization was to foster responsiveness to citizens' needs and promote better performance, it appears that in the water sector, the Organic Law did not fully consider the implications of the process. Since 2000, the development of the legal framework has deviated from the Organic Law's original intention. Rather than completely devolving water and wastewater services, its *de facto* application has resulted in a more limited form of decentralization. This reconsideration was appropriate given Albania's fragile system of governance and well-known lack of capacity at the local level. Implementation of the Organic Law has demonstrated that LGUs are not able to fulfill the broad range of competences implied by the Organic Law for the water and wastewater sector, most notably price-setting authority.¹⁴ On the other hand, the water sector's deviations from the original decentralization framework have not been matched by appropriate amendments to the Organic Law. While it is understandable that the Government may be wary of revisiting the current legal basis for water sector decentralization after it has been agreed by parties across the political spectrum,¹⁵ this inaction has stalled decentralization in the country's two largest municipalities, Tirana and Durrës, on the grounds that the Organic Law has not been applied correctly. This dispute has triggered an acrimonious political debate, led by the mayor of Tirana, over the transfer of ownership of the water companies in these cities. So far the Government has not been able to resolve the impasse. Overall, the legislative framework for decentralization in the water sector has been inconsistent and remains incomplete.

18. Price-setting authority for water and wastewater services remains unclear. Article 73 under the Organic Law of LGUs specifically assigned LGUs the right to set service tariffs. At the time, this authority was under the remit of the WRE, based on Law No. 8102. The first transfers of water supply utilities occurred in 2004, but tariff-setting authority remained with

¹⁴ One fact effectively illustrates this statement: From February 2006 to May 2008, the authority to apply tariffs was vested in the local governments that became owners of the utilities. The role of the Water Regulatory Entity (WRE) was limited to verifying tariff compliance with the tariff-setting methodology (to be issued by the WRE). Despite this limitation, during the entire period in question, all the utilities that applied a change in their water and wastewater tariffs did so by applying at the WRE, ignoring the amendment to the law. These included water utilities that had been transferred to local governments (e.g., Lushnje city, Pogradec, and Delvine). This was not the result of misinformation; on the one hand, it suggests that utility managers trusted the WRE's judgment in determining tariffs much more than that of the local governments, and on the other, the indifference among LGU officials with regard to discharging this function. There is a widespread opinion among water utility managers that local governments would tend to lower the tariffs for political expediency, thus seriously undermining the sustainability of water and wastewater services.

¹⁵ It should be noted that the Organic Law on LGUs is proposed to be amended only for the water sector.

the WRE. This contradiction was corrected in February 2006 with the first amendment to the Organic Law, which assigned tariff-setting authority to those LGUs where the transfer of shares/assets had already occurred and limited the role of the WRE to verifying compliance with the tariff methodology. In May 2008, Law No. 8102 was again amended to reassign to the WRE full authority to set water and wastewater tariffs. This second amendment¹⁶ came after the issuance of DCM No. 660, which launched the wholesale transfer of all water and wastewater utilities to local government, and again created conflict with the Organic Law of LGUs over price-setting authority.¹⁷ The reasoning behind the change was that the LGUs that had already taken ownership of their assets/shares had declined to exercise their price-setting functions during 2006–2008, when it was granted to them. The latest amendment to Law No. 8102 explicitly requires a formal opinion from the LGU concerning the tariff proposal submitted by the utility, though the WRE can disregard this opinion. This requirement has arguably placed the WRE in a position that might be regarded as potentially confrontational by the LGUs, thus making it difficult to render an impartial judgment on tariffs. Based on WRE evidence and statements, out of 14 tariff decisions made after the second amendment of Law No. 8102 (that is, during 2008 and 2009), most were consistent with the opinion of LGUs.

19. A second inconsistency concerns the preservation of the legal status of water and wastewater utilities. The normative act on the transfer of ownership in 2007¹⁸ required that the status of joint-stock companies be retained for two years after the transfer to LGUs, after which LGUs would presumably be free to create their own municipal operations. However, the government policy articulated in the Reform Plan of 2007–2009 and other official policy papers¹⁹ favors the merger of water and wastewater systems. If this policy is not supported by legal amendments and action, further sector fragmentation may take place through the disintegration of existing companies to create a number of smaller utilities that would typically each serve one LGU. The dilemma is that local councils may prefer to have a utility of their own that they may use as a vehicle for patronage and political advantage. As long as the central government steps in to cover operating deficits and investment funding, there is a risk that local councils would not require utilities to be soundly managed, including through the achievement of full cost recovery. The amalgamation of small systems to gain economies of scale and improve utility performance may then be sacrificed for short-term political expediency, thus risking deviations from the “optimal” **utility size**. The Government’s approach in addressing these policy trade-offs has been to adopt the principle of “voluntary amalgamation with incentives,” as a compromise option between the extremes of mandatory amalgamation and voluntary amalgamation. However, no specific incentive framework has been elaborated and put in place to date.

16 Law No. 9915, dated May 12, 2008.

17 In the General Dispositions of Law No. 9915, it is stated that “all the previous laws that conflict with the provisions of this law become null and void,” presuming that Article 73 of the Law on the Organization and Functioning of Local Government is automatically invalidated with regard to water and wastewater services. However, it is debatable whether that disposition of Law No. 9915 is sufficient. The Organic Law is, according to Article 81 of the Albanian Constitution, one of those legal acts in the “hierarchy,” the adoption of which requires a three-fifths majority. Hence, if the Parliament wishes to adopt a separate law that establishes different authorities for the LGUs, the new law must also be qualified as an Organic Law, meaning that it must have as a prerequisite that approval would require a three-fifths majority, which Law No. 9915 did not. Despite the majority by which Law No. 9915 was approved, the fact that a qualified majority was not a precondition violates the legitimacy of the abrogation of price-setting authority of LGUs for water and wastewater services, as set out in Article 73 of the Law on the Organization and Functioning of Local Government.

18 DCM No. 660 of September 2007.

19 See, for example, Government of Albania Interministerial Group. 2010. “Regionalization: A New Philosophy in the Water Supply and Sewerage Utility Sector.” (January).

20. A number of LGU's have objected to this provision of DCM No. 660 on the grounds that it contradicts the Organic Law's definition of water services provision as an own function. LGUs argue that the requirement that utilities' joint-stock status be maintained for a period of time constitutes an unacceptable condition for LGUs, which should have the freedom to choose the organization and status of utilities in their jurisdiction. This is based on the assumption (though weakly articulated in policy) that LGUs also assume responsibility for cost recovery—that is, that rights come with responsibilities. Starting from the original premise of the Organic Law on LGUs, this argument seems justified. For the water and wastewater utilities that were transferred, the two-year deadline has already expired or will expire shortly, thus enabling the respective LGUs to proceed with further fragmentation. Clearly, this is not the case for the companies that have not yet been transferred, including Tirana and Durrës water and wastewater companies.

21. The decentralization legal framework in the water sector has some inconsistencies and remains incomplete. In an effort to move forward with the transfer of ownership, which had been lagging, the Government carried out the next set of transfers without having drafted some accompanying measures that would normally have preceded the process. In addition, water sector decentralization occurred in spite of limitations in many LGUs' capacity to discharge their responsibilities as owners of the utilities. While the Government made some provisions to address the capacity constraints, in the form of guidelines for the shareholder's assembly and supervisory boards and provision of qualification criteria for the people who would manage the utilities, this does not appear to have been effective. Completing the process of water sector decentralization in Albania will require capacity-building measures and the drafting of primary and secondary legislation to make decentralized water services provision viable.

22. One particularly important missing piece of primary legislation could address problems with decentralization in the water sector. Article 10 of the Organic Law of LGUs states that “in instances when communes and municipalities do not have sufficient funds or means to comply with the national standards and norms, the central government shall provide them the necessary support.”²⁰ Yet the criteria for handling the cases where LGUs are unable to exercise their legal functions or comply with national standards—especially the conditions that give the central government a right to intervene and what interventions may be appropriate—remain to be defined with regard to the water sector. In a less extreme case, the distribution of subsidies in direct support of LGUs is not undertaken on the basis of any sector-specific criteria, thus leaving room for lack of transparency in their usage. The Government might therefore consider reforms to address these inconsistencies and gaps, with particular focus in the following areas: (i) promoting the regionalization of utility management and service provision, with a view to achieving economies of scale (as discussed above); (ii) financing measures to increase the capacity of LGUs to assume their assigned responsibilities; (iii) conditioning financing and subsidies on compliance with legislation; and (iv) ensuring that utility incorporation is conducted appropriately, including reviewing legislation to define the role of mayors in decisions concerning the delivery of water and wastewater services (for example, by defining a role in the appointment of the SCs of municipal or regional utilities); and (v) addressing legislative gaps, including a follow-up of Article 10 with more specific criteria for supporting LGUs that need assistance.

²⁰ Speech given by Edi Rama, mayor of Tirana on December 5, 2007, during the round table of mayors of regional capitals and the central government representatives on the process of decentralization.

23. The implementation of decentralization would benefit from analysis to fill important gaps in water sector knowledge, policies, and practices, which do not require legislative action. First, it would be useful to complete an inventory of water and wastewater systems in Albania. Present sector knowledge, based on the Monitoring and Benchmarking System, largely excludes rural systems. Yet the Government wishes rural systems to be attached to larger urban utilities in order to facilitate the administration and financing of safe water and adequate sanitation. Elaborating investment incentives in which investment allocation is positively correlated with improved operational performance would help strengthen accountability and minimize the risk of moral hazard. Similarly, defining new criteria for the distribution of subsidies and reforming the subsidy system would assist in ensuring accountability.²¹ Finally, water utilities should be required to prepare business plans and it may be helpful to analyze the effects of requiring performance agreements between LGUs and the water company. It may be difficult to enforce such performance agreements, however, as both parties are in the public sector and the availability of investment and operating subsidies gives utilities a soft budget constraint.

24. These elements are part of the central government's strategy for the water sector, and have been articulated in the Government's Policy Note and Action Plan (PNAP) of 2007. The PNAP policies have not been reflected in the legal framework in normative acts. However, the Government is currently undertaking the preparation of a new National Water Supply and Sewerage Services Sector Strategy, which is expected to be issued later in 2011. The Strategy, along with a Water and Sanitation Sector Capital Investment Master Plan currently under preparation, will set the broad framework for financing criteria and distribution of operating subsidies, as well as a range of other sector reform actions.

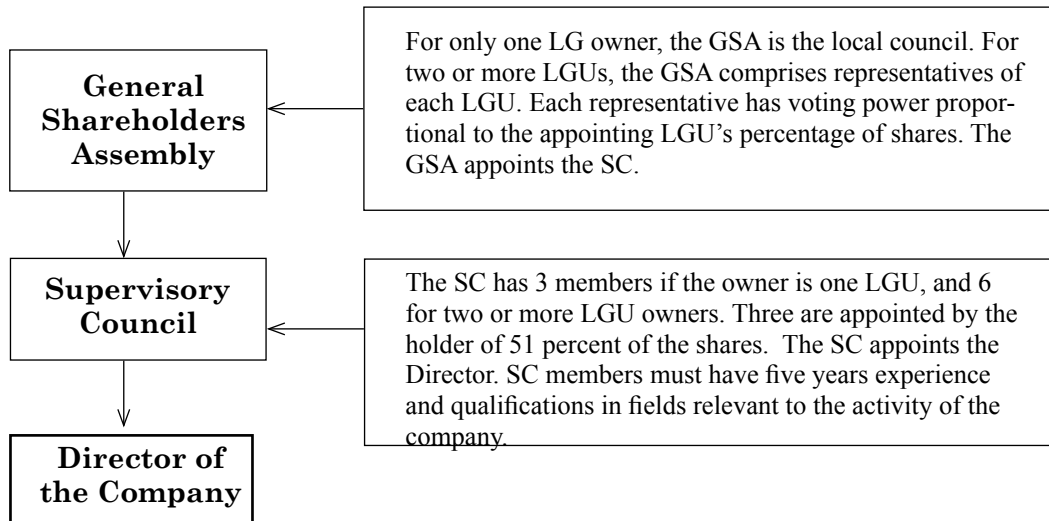
B. Institutional Instruments

The structure of the water company

25. Transferred water and wastewater companies are organized as joint-stock companies under the Law on Commercial Companies, but shared ownership complicates corporate governance.²² Company shares are owned by municipal shareholders, while assets and liabilities are directly owned by the company itself. The shareholders are represented by a General Stakeholders Assembly (GSA), which is the same as the municipal/communal Local Government Council if the company serves only one LGU. The administration of the water companies becomes more complex when two or more LGUs share ownership (Figure 7.1). The GSA is composed of representatives of LGUs, who are authorized to vote in GSA meetings only on matters that should have been agreed beforehand in the respective local councils. This mechanism is derived from the Law on Commercial Companies, but its application at the local government level is cumbersome. It is doubtful whether a private operator would be willing to engage in agreements with a partner that has become entangled in such a complicated decision-making procedure, given the added risk associated with the additional complexity. The relationship between the GSA, the SC (equivalent to a Board of Directors), and the Director (chief executive) of the joint-stock company utility is shown in Figure 1.

²¹ The new approach outlined in the Strategy of Decentralization of 2007, issued by the Ministry of Interior, and the draft National Water and Sanitation Sector Strategy is to enable the subsidization of a lifeline water supply, instead of continuing to subsidize operating deficits.

²² Law No. 7638, dated November 19, 1992, which applies to both private and public corporations.

Figure 1: Water Utility Institutional Structure

26. Water utilities are the only example of joint-stock company status for public utilities or corporations owned by one or more LGUs. There is no precedent for such jointly owned public companies or corporations elsewhere in the country. This institutional structure presents difficulties, as LGUs have little experience in exercising oversight of such companies and there is a risk that management of water utilities will become politicized. Experience shows that there is a tendency for local councils to engage in bargaining in the interest of political and private interests.

27. Given these corporate governance arrangements, the mayor's office has limited influence in the running of water companies. The Albanian mayors and heads of communes have openly expressed concern over this issue and have identified it as an obstacle to successful functioning of the water sector. In cases where transfers have progressed without problems, the SCs include at least one official from the mayor's office (usually a deputy mayor). Conversely, mayors in Albania tend to enjoy substantial political influence and can effectively obstruct the decision-making process of the local councils by influencing their own party members in the local council. There are several arguments in favor of giving mayors a role in water company management. As the executive in charge of delivering all other municipal services, the mayor's office has greater expertise than the local council in the field of public services. Because the mayor is the public face of the municipality, the population tends to hold the mayor accountable for providing public services, including water and wastewater services.²³ Moreover, the decision-making process in the mayor's office is more agile than that of the local council.

²³ *Decentralizimi ne Shqiperi, Sherbimet, Pergjegjshmeria, dhe Marredheniet e Qeverisjes Vendore me Qytetaret: Rezultatet e Vrojtimit qytetar 2005–2007.* (Decentralization in Albania, Services, Accountability and Relations between Local Government and Citizens: Results of the Citizen Survey 2005–2007). Financed by the United States Agency for International Development (USAID). Survey results show that the majority of Albanian citizens regarded the municipal executive (i.e., the mayor) as the institution responsible for providing water and wastewater services even before the transfer of these utilities to LGUs. In 2005 and 2007, survey results indicate that 65 percent and 62 percent of the Albanian citizens, respectively, perceived the mayors as responsible for water services. For wastewater services, the figures were 84 percent and 90 percent, respectively. While these data point to the poor level of information among Albanian citizens, they also imply that citizens' expectations of mayoral responsibility for these services have only increased after the transfer.

28. The decentralization experience may not yet have revealed all the potential problems that the present arrangements may generate because the transfers are still recent. It is becoming increasingly clear, however, that the corporate governance arrangements for water companies whose shares have been transferred to the LGUs are not workable.²⁴ Applying the Law on Commercial Companies to the institutional structure of the water companies in Albania does not appear to adequately reflect realities at the local government level or the specific needs of the water sector. As a result, there may be a need to develop a special legal framework for the water companies. Furthermore, it can be argued that the application of the Law on Commercial Companies is not in line with the role of the local councils, which are not involved in executive tasks that instead fall within the remit of the mayor's office.

29. The Government may wish to consider revising the institutional arrangements for decentralization in the water sector, possibly by drafting a specific law for the provision of water supply and wastewater services. In particular, there is a need to clarify the respective roles of the local council, the mayor's office, and the water company in each municipality. Local councils and mayors are political representatives and should have a role in the oversight of utilities, though measures should be in place to ensure that their participation does not interfere with sound professional management of the utilities. Allowing mayors a role would require modifying legislation and aligning accountability for service quality with authority to take corrective action. These changes would address the corporate governance issues associated with public utilities that are owned by the local government, where the owner (the council) and the executive body (the mayor's office) are separate. The mayor's office should also have a role in the election of utility's SC and in the oversight of utility performance. Decisions such as whether to contract out service provision or sell assets (whenever permitted by law) should remain with the local council. This aspect would also be addressed under a Public Corporate Law.

Overview of the broader legal and institutional framework in the water sector

30. In Albania, the functions of policy setting, service delivery, and regulation are unbundled and assigned to different institutions and levels of government. Policies are set at the central government level. The MPWT is responsible for policy, strategy, investment planning and allocations, and the monitoring and benchmarking of sector performance. The sector policies and strategies that are defined at ministry level serve as the foundation for laws that are approved by the Parliament and for other normative acts approved by the executive branch. As discussed above, delivery of water supply and wastewater services was assigned to LGUs by the Organic Law of LGUs,²⁵ and this provision became reality when DCM No. 660 transferred all water and wastewater systems and utilities to LGUs by December 31, 2007. The regulation of water and wastewater services is assigned to the Water Regulatory Entity, an independent regulator at the central government level.

31. Established in 1996, the WRE is a national, independent body. Its independence is underpinned by efforts to ensure transparency in the nomination of its commissioners, who are appointed by the Parliament, as well as financial independence from the state budget. The

²⁴ It should be added that in communal systems, which are managed by the communes that own the assets, the above-mentioned institutional arrangements do not apply. Their systems are typically managed through the services sector of the commune, within the authority of the local mayor, or as public enterprises, which are under the direct responsibility of the mayor.

²⁵ Article 10, paragraph 3/I/a, b.

WRE is funded exclusively from fees paid by the utilities,²⁶ which would seem to accord greater influence to the largest utilities. The WRE's legal mandate has changed twice, in 2006 and 2008. Its competences include: (i) licensing water and wastewater commercial entities; (ii) approving tariffs and fees for wholesale and retail water supply and wastewater services;²⁷ (iii) establishing performance and service standards²⁸ for licensed utilities and enforcing their compliance;²⁹ (iv) establishing tariff methodologies for retail and wholesale drinking water and wastewater services; (v) setting standards for investment programs and the sale of assets;³⁰ (vi) reporting to the Government on the situation in the water and wastewater sector based on information from the utilities;³¹ (vii) organizing public hearings at the discretion of the WRE Commission Chairman; and (viii) applying administrative and monetary sanctions. The WRE is composed of a decision-making body, the Commission, and an executive body, the Agency. The Commission is composed of five members, including the Chairman. Based on the current, approved structure³² of the WRE, the Agency should have 19 employees, of which 14 are professional staff, but the Agency is not fully staffed at present.

32. Despite its considerable authority, the WRE has not been able to fully exercise some of its functions. Although the law assigns to the WRE the task of exercising regulatory oversight of water utilities, the WRE – to date -- has not defined minimal service standards, nor has it organized public hearings, though these activities fall within its mandate. A considerable number of unlicensed commune-level water providers continue to provide water supply services to their constituents. Yet the WRE has no dialogue with those communal systems that are administered independently from the 55 existing utility joint-stock companies, nor has it established relevant licensing rules. Although these systems are not incorporated, they are operators by law and thus also under WRE's remit. The WRE's performance has been weak in the past, and its tariff methodology and application of tariffs can be criticized. Most observers believe that the tariff level applied by the WRE is below the potential of affordability. However, the WRE is the institution in Albania with the most experience in tariff setting—12 years in a field where no other sector institution has had any input.

33. The Government may therefore consider measures to strengthen the WRE's ability to discharge its responsibilities more effectively. In the future, it would be advisable for the GDWS to allocate subsidies according to utility performance, drawing from clear and measurable performance criteria and targets, which could be determined by the WRE through its tariff review process. To this end, the Government may consider drafting, in close cooperation with the WRE, legislative amendments requiring that MPWT's investment and subsidy-related functions be based on sound criteria and processes. Such amendments would require bringing the Organic Law on LGUs in line with Law No. 8102 on the WRE. In addition, it will be important for the WRE to establish national service standards to guide the performance of LGUs and the targeting of central budget aid. Enabling the WRE exercise its duty to license all operators of water and wastewater systems, including communal administrations that operate their own

26 The original Law No. 8102 allowed for initial funds from the state budget. The amendment of 2008 (Law No. 9915) removes any reference to financial support from the state budget.

27 Law No. 8102, Art 14, point (b) (amended by Law No. 9915).

28 "Service standards" indicate those that the Commission may issue, as opposed to other technical standards issued by other bodies.

29 Law No. 8102, Art 14, point (d).

30 Law No. 8102, Art 14, point (c), (amended by Law No. 9915).

31 Law No. 8102, Art 14, point (f) (amended by Law No. 9915).

32 The current structure is approved by Decision of Parliament No. 162, dated February 28, 2008.

systems, will imply drafting specific, appropriate licensing rules for communal systems. Finally, the current tariff setting policy would benefit from a thorough revision in order to move toward affordable, efficient, and sustainable tariffs. GTZ is currently assisting the WRE with a capacity-building program, which will address *inter alia* the improvement of tariff methodology, and other measures are being taken by WRE itself to improve its performance.

Water quality and wastewater discharge control

34. Water quality and wastewater discharge control are the responsibility of the Ministry of Health. This mandate is exercised through the State Sanitary Inspectorate and district Public Health Departments. Through their inspectors, these institutions perform daily testing at predefined checkpoints. This system of sanitary control is not extended to communal systems that are not administered by the water companies. In 1998, the Council of Ministers approved mandatory water quality standards that are similar to those set by the World Health Organization. Compliance with some of these parameters seems unrealistic, however, particularly for those that require treatment technology that is currently unavailable in Albania. To comply with these standards, significant investments would be needed in the infrastructure of water utilities. Intermittent supply compromises water safety, as shown by recurring outbreaks of water-borne diseases. Effluent standards are even more unrealistic due to the lack of wastewater treatment plants, although the situation is expected to change following the completion of 14 wastewater treatment plants that are currently under construction.

35. It would be strongly advisable for the Ministry of Health to provide for the regular monitoring and control of water quality in all public water supply systems. This quality control should be based on realistic standards that require utilities to improve their performance. This kind of monitoring would require the GDWS to prepare an accurate inventory of all water supply and wastewater systems.

The status of institutional decentralization in the water sector

36. Before 2007, the transfer of assets occurred in a limited number of cases. This was accomplished either by detaching rural, independent systems from existing utilities and transferring them to the communes; or through direct investments in stand-alone systems in communes, financed by the central budget or by foreign donor organizations (mostly non-government organizations), after which the new systems were passed into the hands of LGUs. The number of commune-level systems is estimated at around 600, but no accurate data exist. A few utilities' shares were transferred to LGUs in cases where the service area was limited to only one LGU. The bulk of ownership transfers in the form of shares of water utilities took place after September 2007, subsequent to the issuance of DCM No. 660. By that decision, the shares of the 47 remaining water utilities were to be transferred to 227 LGUs, out of which 54 are municipalities and 173 are communes. The Minister of Economy instructed all eligible companies to register at the National Registration Center.³³ Companies were registered in the name of the new owners, the LGUs, and the previous SCs were retained until new ones could be elected during the initial meetings of the new shareholding assemblies. Transfers are considered

³³ Non-eligible companies include those that were not joint-stock companies at the time of the transfer, those that did not have an orderly registration, and those that were under contract with a private operator. Four companies fit this description at the time of the transfer, and they are currently under the process of becoming eligible.

complete if the company has been properly registered and a new SC representing the LGU(s) served by that company has been appointed.

37. Several transfers have not been completed, for a variety of reasons. These include the water companies of Tirana, Durrës, Lezhe, Elbasan, Rubik, Rreshen, and Gjirokaster's rural areas. In Lezhe, the local council elected its SC member, but the mayor rejected the decision on the grounds that it did not comply with the requirements. The prefect returned the decision for review, but the council reconfirmed its first choice. According to Lezhe council officials, the question is now in court. The Gjirokaster Regional Company is still in the process of being transformed into a joint-stock company, which is necessary prior to transferring the shares. In Elbasan, the registration of shares has been completed but it remains in effect the property of METE—a requirement of the management contract until its closure. In Rreshen, the assembly has not been constituted because the participating communes have required that Rreshen city form its own company and detach itself from joint ownership. In Rubik, the water company is experiencing problems with its first registration and is being followed legally by METE. This prefect of the region has rejected this request, and the issue is still unresolved. The consequences of uncompleted transfers can be serious, as service providers may be in breach of national legislation or policies and this can make it difficult for utilities to conclude financing agreements with external lenders and/or investors. .

38. The utilities that have been transferred completely constitute 83 percent of the total number of utilities. These involve 76 percent of municipalities and 88 percent of communes. The utilities that now belong to LGUs serve 53 percent of the population. By contrast, the combined service area of the Tirana and Durrës water companies, whose transfer to the local government units has not been completed, accounts for over 1.2 million people,³⁴ or 37 percent of the country's population.

39. As mentioned above, the mayors of Tirana and Durrës have refused to assume ownership of the water and wastewater utilities serving their municipalities and have publicly objected to the transfer. Given the decrepit state of assets and the utilities' poor financial performance, the mayors have refused to accept the utilities' transfer without guarantees of ongoing financial support from the central government. In addition, as discussed above, both mayors have strongly objected to the legal framework that deprives the mayor's office of any authority over the management of the water company. Finally, they are reluctant to have their own populations cross-subsidize the financially weaker rural communes and thus object to the Organic Law's requirement that their water sector systems remain within the framework of the existing regional utilities, which implies joint ownership and delivery of services. These objections have been raised in the press, in the meetings of the Association of Municipalities, and in public speeches made by the mayors.

40. The creation of shareholder assemblies and the election of the SCs and company directors in other LGUs has had mixed results. In a number of LGUs—including Shkodra, Korca, Berat, and Kucova—the transfer process went smoothly. In these cities, the municipal councils have one dominant party and the respective mayors enjoy good personal relations with the municipal councils and the company directors. In Shkodra, the head of the SC is one of the deputy mayors. These factors have helped support good performance: Korca water and

³⁴ All data are based on the LGU lists attached to DCM No. 660, and the figure for the total population living in Albania is assumed to be 3.2 million. The figures are as of 2007. Due to continuous migration toward Tirana and Durrës districts, the population figures for these two cities may have risen.

wastewater company³⁵ is the best performing company in Albania, and the Shkodra and Berat-Kucova companies are performing relatively well and receiving significant support from foreign donors.

The impact of decentralization on utility performance

41. Performance indicators in the water sector do not reveal any clear trends (Table 2), possibly because the transfers are recent. A detailed analysis of Albania's nine major water companies³⁶ shows that operating revenue covers only 68 percent of total costs. Subsidies provide for about 20 percent of the total, while the remaining 12 percent (constituting depreciation) remains uncovered. This financial shortfall leads to a failure to maintain assets and/or to an increase in utility indebtedness.

Table 2: Key Sectorwide Performance Indicators for Albania's Water Utilities

Indicator	2006	2007	2008	2009
Water Coverage (%)	73	76	78	79
<i>Urban</i>	85	87	88	90
<i>Rural</i>	49	55	54	58
Sewerage Coverage (%)	43	45	45	46
<i>Urban</i>	67	68	66	68
<i>Rural</i>	1	3	2	2
Non-Revenue Water (%)	63	63	72	70
Metered Connections (%)	34	37	41	44
Financial Working Ratio	1.20	1.19	1.25	1.19
Collection Rate (%)	77	74	78	74.8
Staff per 1,000 Water and Sewerage Connections	13	12	14	13.6
Hours per Day of Water Supply	10	11	13	11
Water Quality Compliance Rate: E-coli	91	99	98	99
Water Quality Compliance Rate: Residual Chlorine	48	59		

Source: GDWS & Institute of Public Health.

42. Efficiency indicators are particularly disappointing. With a non-revenue water rate of 70 percent, it will be impossible to reach financial autonomy and, as a consequence, institutional autonomy based on professionally managed operations.³⁷ High rates of non-revenue water in turn cause maintenance to be neglected and asset deterioration to accelerate. It is politically difficult for the WRE to approve significant tariff increases to such inefficient utilities; yet the utilities need higher tariffs to produce cash to pay for operating expenses, including preventive maintenance. Collection rates are still low at an average of 78.3 percent of billings, though it is important to note that there are exceptions, including the Korca municipal water and wastewater utility, whose collections rate of 97 percent is well in line with the international benchmark of 98 percent. Another common efficiency indicator is the number of staff per 1,000 water and

³⁵ Korca water and wastewater company is the company that serves Korca Municipality, distinct from Korca Regional Water Sector Utility, which serves only rural areas (a number of communes in the Korca region).

³⁶ Data were obtained by the GDWS Monitoring and Benchmarking Unit. These nine companies are selected because their data are deemed more reliable than the rest.

³⁷ As mentioned above, an international benchmark for non-revenue water is on the order of 25 percent (although there are city-state utilities, such as Singapore, that have a non-revenue water rate of only 4 percent).

sewerage connections. At 13.6, staffing levels in Albania are high compared to the international benchmark of 4—all the more so because the Albanian definition includes both water supply and sewerage connections, whereas only water supply connections are included elsewhere. After adjusting for this difference, staffing levels in Albanian utilities appear even worse. Possible explanations include both widespread political patronage and the excessive complexity of systems.

C. Economic Instruments

43. Economic and financial instruments of water sector governance comprise measures to encourage efficiency, including pricing, investment financing grants, and subsidies. In Albania, these instruments are controlled by central government institutions. In particular, the pricing of water and wastewater services falls within the remit of the WRE, and the allocation of investment funds and operating subsidies is implemented in practice by the MPWT.

Pricing of services

44. The WRE approves tariffs that are valid for at least one year, based on its tariff-setting methodology.³⁸ Tariffs are set based on the principle of an average tariff, drawing on a tariff proposal and data submitted by the utilities. The information collected by the WRE from licensees is limited compared to the information collected by the GDWS Performance Monitoring and Benchmarking Unit,³⁹ but neither organization consistently verifies data reported by the utilities.

45. A comparative analysis of the tariff levels approved by the WRE and applied by 30 companies⁴⁰ over the period 2006–2009 shows that, on average, tariffs increased by 11 percent⁴¹ while total costs increased by 262 percent. The companies in the sample serve 83 percent of the total population. The significant gap between tariffs and costs illustrates the WRE's principal dilemma, as it can be criticized politically for approving tariff increases for highly inefficient utilities. There is also a risk that tariff requests to the WRE are modest given the reluctance of local councils to approve increases for reasons of political expediency. Some evidence suggests that WRE does approve tariff requests that have been agreed by the respective local councils.

46. On a consolidated basis, the utilities have incurred cash operating losses. In 2007, 2008, and 2009, respectively, revenues covered only 59 percent, 60 percent, and 62 percent of

38 Issued and approved by Decision No. 3 of the WRE on April 8, 1999. However, from 2012 the WRE will apply a 3-year term of tariff, as will be approved in 2011. While it seems reasonable, this measure will not be effective if tariff review and approval is not based on sound business planning by the water companies. Currently, measures are applied sporadically and in an uncoordinated fashion.

39 Although the Monitoring and Benchmarking Program has been operational for three years, the WRE continues to collect data independently.

40 The service areas of these 30 companies for which data are available and reliable cover a total population of 2,633,625, of whom 2,088,600 are served. Data on population, tariff levels, and revenue are taken from the Monitoring and Benchmarking Unit at GDWS, and cost data from the Ministry of Finance's Debt Department.

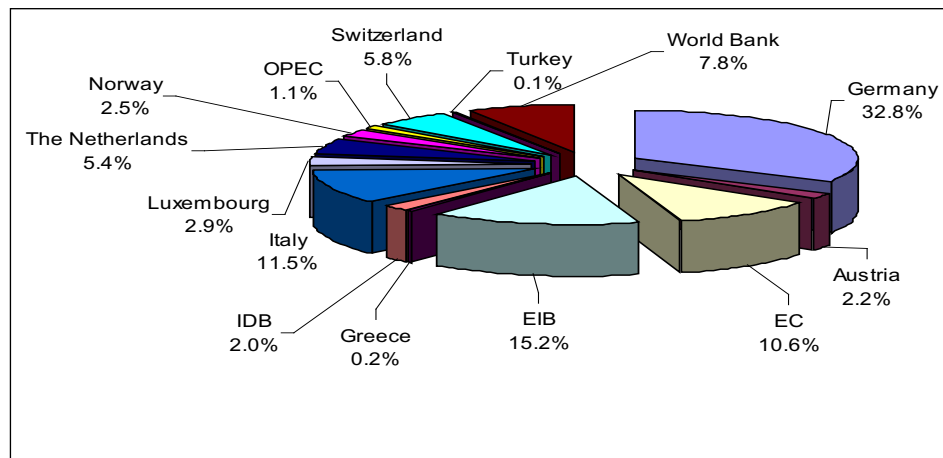
41 This is a weighted average, calculated on the basis of the share of total 2008 revenues represented by three customer categories: households (60 percent), public entities (21 percent), and industry (18 percent). The share of wholesale clients is only 1 percent and has been omitted.

total costs.⁴² This dire situation is again the result of the high levels of non-revenue water in Albania, which points to the utilities' reluctance to even bill for water supplied. One explanation for this is the tax regime in Albania (and elsewhere), under which utilities are required to pay the Value Added Tax (VAT) of 20 percent on the basis of monthly billings, rather than monthly collections. Given the low collection rates, it is understandable that utilities may be reluctant to bill certain consumers for water since they stand a good chance of never collecting for bills on which they have to pay VAT, further straining their operating cash flow.

Capital investment financing

47. Financing from donors and IFIs is the main source of capital investment in Albania's water and wastewater sector. Total cumulative donor commitments are €318 million, while cumulative disbursements are about €87.9 million. Annual disbursement rates were €21.5 million in 2007, and rose to €33 million in 2008 and € 33.4 million in 2009. Figure 2 shows the most recent distribution of donor commitments in the water and wastewater sector. A recent commitment by the Government of Japan of JPY 11.1 billion (US\$ 120 million) is not included in the graph.

Figure 2: Donor Commitments in the Water and Wastewater Sector



Source: Department for Donor Coordination, Prime Minister's Office.

48. Central government capital financing is allocated through two budget lines: (i) capital investments (defined as large projects) and the Albanian Government's contributions to donor-financed projects; and (ii) small capital investment projects allocated through the competitive grant scheme. At end-September 2009, the total value of ongoing and planned investment projects⁴³ in the water and wastewater sector was about US\$ 461 million. □ The Government has increased planned investments over the last three years, from US\$ 22 million in 2007 to US\$ 35 million in 2009 (Table 3).

⁴² Data for 2007 and 2008 were drawn from GDWS. 2007 and 2008 Annual Reports of Monitoring and Benchmarking Program. 2009 data were reported by GDWS and are available online at <http://www.dpuk.gov.al/mat.php?lang=1&idm=73&idr=345> (accessed on February 9, 2011).

⁴³ Total value includes the value of large investment projects, competitive grants, design, and technical control costs, and other costs (VAT, expropriation).

Table 3: Water Sector Investments in Albania (US\$ million)

	Investment Type	Total Investments	Large Investment Projects	Competitive Grants	Design and Technical Control	Other Costs (VAT, local costs, expropriations)
2009	Planned	34.4	9.7	16.4	0.3	8.0
	Realized	24.8	7.8	11.6	0.0	5.4
	% Realized	72.0	80.2	70.5	0.5	68.2
2008	Planned	33.7	9.9	10.8	1.1	11.8
	Realized	10.0	2.2	4.9	0.4	2.4
	% Realized	29.7	22.5	45.9	37.4	20.3
2007	Planned	31.6	22.0		0.4	9.2
	Realized	27.9	19.8		0.3	7.7
	% Realized	88.3	90		77.7	83.7

Source: MPWT.

49. The Competitive Grant Scheme (CGS) is a tool the central government uses to finance capital investments for LGUs. Communes, municipalities, and regional councils can apply for competitive grants. Upon the award of a grant, the LGU implements the project. Decisions about the distribution of grants are made by the Competitive Grant Committee, comprising one member from the Ministry of Finance (MoF), one from the Ministry of Public Works and Transport, one from the Ministry of Interior, and one from the Association of the Municipalities and the Association of the Communes. The GDWS acts as the technical secretariat, accepting proposals, screening them for incomplete documentation, and evaluating them against the established criteria from the Budget Law and technical criteria established by the Ministry of Public Works and Transport.

50. Although there are no formal limits for project financing, the Competitive Grants Committee has tended to approve more projects than the available financing would allow in order to spread funding more widely around the country. As a result, it is not uncommon for partially financed projects to be started each year but remain unfinished due to lack of funds. This approach is detrimental to the investment's effectiveness and may create a climate of mistrust between the citizens and their LGUs due to unmet expectations.

51. CGS grants are awarded on the basis of evaluation criteria that have some shortcomings. As a result, it is difficult to ascertain whether the assessment of proposals is indeed objective. Four of the six criteria are based on unaudited self-reporting by the LGUs, which is submitted to and reflected in official reports of the Ministry of Interior, Institute of Statistics and others. All criteria require quantitative data, which are assigned scores based on a defined methodology, so that the projects proposed by LGUs can be compared on an objective basis. The MPWT has adopted sub-criteria for the assessment of technical quality.⁴⁴ The application of CGS criteria has been criticized for being allegedly vulnerable to political interference, and many LGUs have complained. Measurable criteria, which would require independent verification of the data reported by LGUs, would help minimize undue political influence.

52. The CGS does not consult with the regions. For this reason, the Regional Development Crosscutting Strategy criticizes the CGS as inadequate.⁴⁵ The new strategy foresees yearly

44 Ordinance No. 18, dated October 30, 2008, issued by MPWT in response to a GDWS proposal.

45 Issued by the Ministry of Economy and approved by DCM No. 773, on November 14, 2007.

negotiations between the regions and the line ministries for the budget needed to implement sectoral strategies for regional development. If substantially strengthened, the regional administrations could have a role in assisting LGUs to draft their project proposals or in advising the CGS on priority investments within their region.

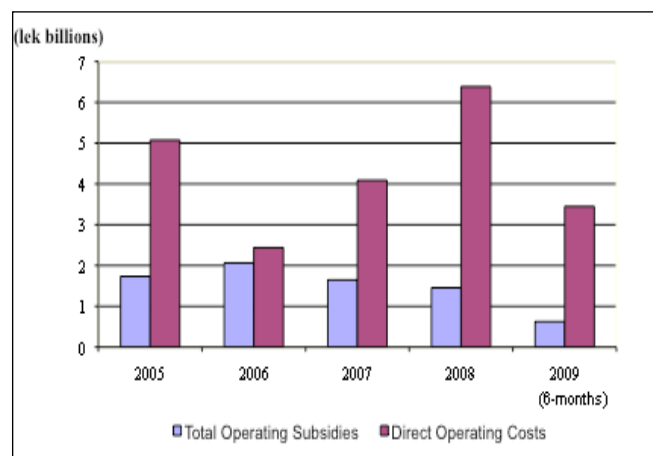
53. Local government financing (excluding competitive grants) represents a small portion of investment in water and wastewater systems. These funds typically go to minor works, such as repairs, in the distribution system. The revenues generated by LGUs come from: (i) local property and business taxes and fees; (ii) transfers from the central government (unconditional⁴⁶ and conditional grants); and (iii) revenue from shared national taxes. By law, communes and municipalities have the authority to independently raise revenue to finance their exclusive (own) functions. The central government provides funds to LGUs to finance the provision of shared and delegated functions.

54. Therefore, the Government may consider establishing clearer criteria for allocating investment funds and competitive grants and applying them consistently. It is critical that the allocation of grants be prioritized on the basis of need and performance.

Subsidies

55. Subsidies to the water sector have decreased steadily during 2006–2009, while costs have risen at a faster pace (Figure 3). While the Government has effectively reduced operating subsidies to the sector, by 25 percent in 2007 and 13 percent in 2008 (net), the direct operations cost has risen by 68 percent and 56 percent, respectively (Table 4). In 2010, however, subsidies rose sharply to about three times the 2009 amount, while costs for the first half of 2010⁴⁷ were close to the same figure for 2009. The reason for this increase is not clear, unless subsidies were used to pay accumulated debts.

Figure 3: Total Operating Subsidies vs. Direct Operations Cost



Source: MoF, Budget Department.

⁴⁶ Not including CGS.

⁴⁷ The figure for operating subsidies distributed in 2010 is about lek 2.5 billion, as provided by the MPWT.

Table 4: Change in Direct Operations Cost vs. Subsidies

Period	Increase in Direct Operations Cost (%)	Decrease in Subsidies (%)
2007-2006	67.8	25.3
2008-2007	56.1	13.2

Source: MoF, Budget Department.

56. The result of rising costs has been growing indebtedness among water sector utilities. DCM No. 660 provided for the cancellation of all water company debt,⁴⁸ but water utilities have continued to accumulate new debt. Debts to the Albanian Energy Corporation alone amount to lek 1.2 billion (US\$ 13 million). In conjunction with low collection rates and tariff levels that fall far short of cost recovery, the increase in operating costs demonstrates poor management at the company level and equally poor governance at the central governance level.

57. In the period 2005–08, total government operating subsidies amounted to about US\$ 18 million annually and paid about 38 percent of utilities' cash operating costs. The criteria for their distribution are based on the guidelines of the MOF the MPWT. However, the subsidy as practiced in Albania is regressive, as it disproportionately subsidizes wealthier consumers who consume the most water. The Government has stated a policy to phase out operating subsidies by 2015, but no study has yet been conducted to analyze how this could be achieved. In the meantime, the draft National Water Supply and Sewerage Services Sector Strategy of February 2011 has sensibly suggested that subsidies be reserved for low-income consumers. The strategy suggests that the subsidy be restructured as a lifeline tariff whereby consumption of up to 20 liters per capita per day would be subsidized for low-income households. If applied correctly, these targeted subsidies would reduce the total level of subsidies, since low-income consumers account for a limited share of total water consumption.

58. Any reduction in operating subsidies would need to be undertaken with due consideration for the sustainability of operations at the company level. At a minimum, such a move should take into account the specific conditions of those water companies that have exceptionally high energy costs due to the technical design of the water supply system. Keeping the responsibility for subsidy allocation outside the WRE creates difficulties in implementing the targeted and effective reduction of operating subsidies.

59. Debt service subsidies, or payments of interest and amortization on loans taken from IFIs, represent another form of central government subsidies in the water sector. Twelve utilities in Albania have financed their capital investments through loans guaranteed by the MoF. With the exception of Korca water and wastewater company, the remaining eleven water companies are in arrears to their creditors. The MoF assists in making the payments as agreed with the IFIs. Updated MoF data show the amount of accumulated unpaid debt to be about US\$ 3.6 million.⁴⁹

60. It would therefore be advisable to reform the system of operating subsidies with a view to subsidizing user charges paid by low-income consumers rather than utility costs. This reform would imply phasing out operating subsidies and creating a system of subsidies

⁴⁸ Excluding interest and principal payments due to donors and IFIs.

⁴⁹ Based on data provided by the MoF, debt is expressed in euros, US dollars and leks. In this report, the relevant exchange rates applied for the conversion of all debt in US dollars are the average values of November 2009.

for low-income households. This switch would ideally be made in parallel with programs to meter all consumers, as good metering data provide an effective means to target subsidies. The decrease in subsidies would be facilitated by measures to increase operating efficiency and by selective tariff increases.

D. Administrative Instruments

Asset value and inventories

61. An asset inventory was carried out prior to the transfer of water company shares, an unspecified number of commune systems exist independent of the assets of the joint-stock companies. As mentioned above, it is estimated that such systems number about 600. Their asset value is not known and, of even greater concern, it is not verified whether all these assets are registered in the balance sheets of the respective LGUs. These systems are built exclusively in rural areas, either with LGU funds, by foreign NGOs with donor money, or by the Albanian Development Fund (ADF) with state budget or donor money. In particular, it seems that once investments by NGOs and ADF are completed, the systems are handed over to the communes, apparently without follow-up by the MoF to verify whether proper asset registration and inventory has been made. It would therefore be expedient for the Government to compile a complete list of communal systems and for the GDWS and MoF to jointly compile an asset inventory for these systems.

Business planning and performance agreements

62. The preparation of five-year business plans is rightly considered a benchmarking tool that would enable improved utility performance and facilitate shareholder assessments of company performance. The importance of business plans has been widely recognized by the Government and is reflected in the Reform Plan of 2007–2009. At the Government's request, the World Bank has funded technical assistance to draft a template for the five-year business plan and support the preparation of specific plans for five utilities in Albania.⁵⁰ The ability of company staff to update and replicate such plans is questionable, however. Above all, the water companies have no legal obligation to prepare and submit such plans, either to the central government institutions or to their shareholders.

63. The WRE may consider making the preparation of five-year business plans mandatory for each utility that is applying for a tariff change, subsidies, or investment grants from the central government. At the same time, the Government may wish to consider providing capacity-building support for utilities' preparation of business plans.

64. Performance agreements are another tool for monitoring and evaluating performance. In association with business plans, performance agreements between the shareholders—the LGU owner(s) and the companies themselves—enable the SC and the shareholders to assess objectively the performance of the water company and its managers. During the last year, a model performance agreement was commissioned by the Government and drafted with technical assistance from the World Bank. To date, however, none of the

⁵⁰ USAID is also funding the preparation of business plans for a number of utilities through the Local Governance Program in Albania (LGPA).

transferred utilities has concluded such an agreement with its shareholders. It must be noted that the effectiveness of performance agreements is reduced by the availability of operating subsidies in Albania, and by the clear difficulty posed by the fact that the utility's owner is also its client. Failure to reach agreed performance targets, such as financial cost recovery, could simply lead the non-performing utility to request higher operating subsidies. This effect of soft budget constraints could be reduced if operating subsidies were abolished.

Financial audits

65. Good corporate governance demands effective systems of internal control. Shareholders expect that company management is in a position to manage the risks the company faces and to put controls in place to deal with such risks. Under the Law on Commercial Companies, the water companies are subject to controls by the MoF, Tax Authorities, and High State Control. In particular, the High State Control has the right to audit any state-owned company, including the water companies. The companies are therefore required to maintain an internal audit department and perform regular internal controls. The MoF exercises annual controls over all water companies through its audit department. Furthermore, the companies are obliged to retain the services of an independent auditor that performs a choice-based control of the balance sheet and financial statements of the company every year. A copy of the auditor's report is submitted to the MoF, and, in principle, the results of the external audit reflect both controls. Tax Authorities control regularly on the disbursement of employees' obligatory social payments. For its part, the WRE has recently issued a "Contract for Water Supply and Sewerage System" that is the basis for issuing licenses to utilities. In principle, this provides an important and more transparent basis on which WRE oversight and licensing can be exercised.

E. Public Participation and Accountability

66. Civil society participation at the local government level is limited, including in the water sector, though opportunities for such participation exist. The lack of a tradition of civil society engagement and the decline in societal trust that has characterized the rapid transformation in the post-communist period, in conjunction with most people's preoccupation with the welfare of their immediate family, seem to reduce Albanian citizens' propensity to become engaged in community affairs, including at the local level. Such opportunities do exist, however, as local council meetings are open to the public, as required by the Organic Law on LGUs.⁵¹

67. There are no civil society organizations or interest groups with specific activities in the water supply and wastewater sector in Albania. One major reason may be the limited number of industrial water users, who are mainly in the Tirana-Durrës areas and often meet their water supply needs from their own wells. This reduces their motivation to demand better services. There is active civil society engagement in the fields of environment and irrigation, however.

68. Nonetheless, water sector performance appears to be an area of high public concern. A series of annual surveys on public service delivery and local government accountability, conducted in ten municipalities by the USAID-funded Local Governance Program in Albania

⁵¹ The only exceptions are when a majority of the local council votes to close the meeting to the public and when the local budget is under discussion.

(LGPA) since 2005, consistently report that the Albanian public ranks poor infrastructure, including water and wastewater services, as the third most important concern after lack of employment opportunities and economic problems. As discussed above, the public is largely unaware of the complex governance arrangements affecting water utilities and tends to hold LGUs responsible for the provision of water and wastewater services.

69. There is a need for communications campaigns to raise the level of public awareness about institutional responsibilities and other issues concerning water and wastewater services, such as cost recovery. By the same token, it would be helpful for the WRE to hold public hearings more frequently.

Potential Risks of the Present Water Sector Governance

70. The Government's policy of decentralizing the responsibility for operations and maintenance of water sector utilities was based on a rationale intended to improve service delivery. Decentralization theory suggests that bringing services closer to local beneficiaries would strengthen accountability for the efficiency and quality of service delivery. This approach corresponds with the prevalent public perception that water and wastewater services are the responsibility of LGUs. However, international experience suggests that decentralization is not a panacea and that decentralization arrangements often leave much room for improvement in achieving intended policy objectives. In this regard, it will be important for the Government to carefully review decentralization arrangements in the water sector to take stock of experience and results to date and identify adjustments needed to improve sector performance.

71. The water sector is fragmented, and there is a real risk that it could disintegrate further. The sustainability of bulk water supplies is compromised when rural communes, adjacent to the main transmission line, siphon off water for their needs without paying for it. The result is that the urban water utility that built the transmission line to meet the needs of its population finds itself without sufficient water to supply to its own customers and without the revenue from the water that has been siphoned off en route. The bulk water transmission line supplying Durrës from the north is a good example of the difficulties in operating and maintaining such regional pipelines. It is likely that the financial sustainability of regional wastewater treatment plants could also be compromised in the absence of clear arrangements for charging all LGUs for the services provided by such regional plants. It will be important for the Government to consider how to ensure the equitable supply of bulk water and wastewater services to LGUs. One possible approach would be to create regional bulk water supply companies and wastewater treatment plants with shared ownership and appropriate voting rights and rules for supplying participating LGUs. The pending completion of 14 wastewater treatment plants, many of which will serve more than one LGU, may be a test case to ensure the effectiveness of such a large investment.

72. About 80 percent of all utilities serve small towns of fewer than 50,000 people, which face difficulties in attracting and retaining the qualified staff necessary to oversee the management and performance of these utilities. In 80 communes of fewer than 5,000 inhabitants, over 70 percent of commune administration staff have no university-level education.⁵² The LGUs, especially those owning majority shares of large companies serving urban centers, are keen to manage utilities whose service areas coincide with municipal boundaries and are reluctant to include adjacent communal systems, which tend to have an investment backlog and might compromise their financial sustainability.

⁵² Ministry of Interior. 2007. Strategy of Decentralization.

73. To address the aforementioned shortcomings of decentralization in the water sector with a view to improving quality of service delivery as well as the financial sustainability of water sector utilities, the Government would need to consider measures in the following key areas:

- **The legal framework needs to be completed to include sanctions for LGUs' non-compliance with legal requirements in the area of water supply and wastewater services**, with appropriate provision for possible intervention by the central government (or the WRE) to remedy social consequences in case of service delivery failure.
- **The sustainability of water supply and wastewater systems needs improvement.** Enhancing sustainability will require physical investments, staff capacity building, and the application of an appropriate, sustainable tariff policy that balances cost requirements, performance, and affordability. A performance-based investment policy and a carefully targeted subsidy scheme focused on support for low-income households would be key elements in a policy aimed at boosting water sector utilities' performance.
- **The government needs to complete the decentralization process and to take action on the regionalization process according to the relevant policy.** It may be necessary for the central government to consider negotiating with some of the municipalities, such as **Tirana and Durrës**, a solution for the completion of the transfer process.

Potential Areas for World Bank Involvement in the Water Sector

74. **Thanks to its substantial experience in the water sector in Albania and other countries, the World Bank would be well-placed to provide relevant expertise, should the Government wish to request such support.** Possible areas of assistance include revising the legal framework to eliminate inconsistencies, completing unfinished sector legislation, and strengthening the financial situation of water utilities.

Priority One: Demand Management in Urban Utilities

75. **A sectorwide program of demand management is suggested to reduce the excessive levels of non-revenue water.** In order to stretch funding further, it is suggested that the demand management program be more selective than those in the past (such as that of the Korca water and wastewater utility, which practically replaced the previous distribution system). International experience indicates that effective demand management has a greater effect on consumption, leakage, and supply in water systems than do investments in physical infrastructure. One example is provided by the water supply utility in Bogota, Colombia, which has calculated the cost-benefit ratios for various sub-programs of demand management (Table 5).

Table 5: Benefit/Cost Ratios of Selected Programs to Reduce Non-Revenue Water

Activity	Benefit/cost ratio
Repairs of leakage in house connections	4.5
Detection of massive consumer fraud	2.3
Repair or replacement of meters	3.1
Leak detection and pipe repairs	12.0
Pressure reducing valves	2.2
Other measures	1.1
Average for all activities	3.2

Source: Empresa de Acueducto y Alcantarillado, Bogota, Colombia.

Priority Two: Energy Efficiency Improvements in Urban Utilities

76. The upcoming wave of sharp increases in electricity rates will have grave consequences for energy-intensive urban utilities in Albania. It is recommended that a sectorwide energy efficiency program be prepared and implemented as soon as possible. The program may include: (i) energy audits in the 55 urban water and sewerage utilities to pinpoint energy usage and scope for higher efficiency; (ii) metering for all water connections (if not already implemented under the nationwide Demand Management Program); (iii) replacement of energy-wasting electro-mechanical equipment; and (iv) hydraulic optimization of improved systems to identify energy-saving operational modes, including the establishment of separate pressure zones that allow for the reduction of water pressure to reduce leakage.

Priority Three: Rural Water Supply and Sanitation Investments

77. The ADF has grown into an effective instrument for preparing and implementing rural water supply and sanitation projects that are subsequently operated by communities. With additional external financing, the ADF could easily scale up its activities. It will be important for such a project to extend water supply service in parallel with sanitation programs, including on-site sanitation. Stronger communal systems would become more attractive partners in agglomerated utilities.

