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Primer on User Charge Reform for Municipal Services

JNNURM City-Level Reform

Final Report

Indo-USAID Financial Institutions Reform and Expansion Project—
Debt & Infrastructure Component (FIRE-D Project)

USAID-TCGI Contract No. 386-C-00-04-00119-00

March 2010

This publication was produced for review by the United States Agency for International Development. It was prepared by The Communities Group International (TCGI), in partnership with AECOM.

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User Charges

ULB Level Reform

1. The Reform

A mandatory reform to be undertaken at the local body/city level is, “*the levy of reasonable user charges by ULBs and parastatals with the objective that the full cost of Operation and Maintenance (O&M) or recurring cost is collected within the next seven years.*” In other words, ULBs/parastatals managing the delivery of any urban service are required to revise user charges in such a manner that by the year 2012, income from user charges of a particular service recovers the full cost of O&M of the service.

This is a very important mandatory reform and is critical for achieving self-sustainability of services and for improving the financial strength of ULBs. Its implementation does not require any additional financial expenditure, only political will. It also does not require any legislation amendments. The Mission objectives for this reform are as follows:

- Establishment of linkages between asset creation and asset management through a series of reforms for long-term project sustainability.
- Ensuring adequate funds to meet the deficiencies in urban infrastructural services.

While the immediate priority for ULBs is to commit to progressive achievement of full cost recovery, this needs to be undertaken with care such that the present in-efficiencies in the services are not passed on to the customer. ULBs shall also protect the interests of vulnerable groups through lifeline tariff mechanisms and cross subsidies and, simultaneously, commit to practical and achievable efficiency improvement plans as listed below:

- Increase in coverage (base) of users.
- Reduction in losses (commercial and technical losses).
- Improvement in method of measurement of service.
- Improvement in billing and collection efficiency.

Since any service improvement plan would require reasonable time and capital to implement, hence, it would be imperative that the ULB commits to user charge reform with immediate effect and ensure recovery of O&M costs, including inflation, during the mission period.

In this primer, the words user charge, pricing policy, cost recovery, and tariff structure are used interchangeably.

Setting rational user charges needs to balance the following four key objectives:

Cost Recovery¹ - Cost recovery is the main purpose of user charges. It requires that, on aggregate, user charges recovered from consumers should produce revenue equal to the financial cost of the service. Moreover, the revenue stream should be relatively stable and should not cause cash flow or financing difficulties for the ULB.

Economic Efficiency - Economic efficiency can be achieved by setting user charges equal to their relevant marginal costs. For example, in many cities the cost of bringing additional water is higher than the cost of supplying existing water, since the cheapest sources/options are developed first. Thus, when additional water is brought at higher cost, user charge rates should be adjusted to reflect this.

Equity - Equity can be achieved when user charges treat similar customers equally, and that customers in different situations are not treated the same. This means that users pay monthly bills for services, which are proportional to the costs of providing the same by the ULB.

¹ Cost recovery can be defined in three ways. *Operational cost recovery* means that the revenues are at least equal to the operational costs of service provision. If the revenues take into account the capital cost also, then it is a case of *full service cost recovery*. Where environmental costs and other external costs of providing the service are included (such as costs of environmental damage), then revenues would ensure *full environment cost recovery*.

Affordability - While the basic objective of user charges is to recover service costs, the charges levied should be affordable to the users. This principle requires the ULB to choose affordable service levels and ensure efficient service. Many times ULBs adapt lifeline tariffs for vulnerable customers, duly subsidizing the costs through cross subsidy mechanisms to address the issue of affordability.

Beside the above fundamental objectives, there are additional considerations involved in setting user charges, which are as follows:

Resource conservation - User charges should serve the purpose of discouraging “excessive” or “wasteful” uses of public service, thus promoting the conservation of depleting resources.

Acceptability - User charges have an inescapable political dimension. A successful user charge is one that is free from public criticism and not objectionable to political leaders.

Simplicity, feasibility, and transparency - User charges should be simple and easy to understand for both users and ULB managers in order to avoid anomalies and disputes. Finally, there should be transparency in every aspect regarding the fixing, revision and implementation of user charges. Public disclosure is a key for ensuring transparency; the users should be provided with full information.

2. Rationale for the reform

The rationale for user charge reform:

- Rational user charges provide financial stability and strengthen the ULBs/parastatals by effectively recovering all the costs associated with a particular urban service. Such financially viable user charges may even generate resources for expanding or upgrading the service. User charges enable ULBs/parastatals to provide services from a demand perspective. They encourage people to realize the need for conservation of precious resources by reducing wastage and optimizing usage.
- User charges can be used as a redistributive mechanism; differential tariffs can provide subsidies to the old and the poor.
- User charges enable allocative efficiency, that is, by fully recovering the operational costs of the urban service, ULBs/parastatals do not divert or consume resources meant for other services or sectors.

The user charge reform shall have the following benefits for citizens, ULBs and state/central governments:

For Citizens

- Rational tariffs coupled with efficiency measures ensure optimum service delivery and thus citizens get value for money.
- Appropriate allocation of the cost of providing services to poor and non-poor groups of urban society.
- Economic tariffs empower the users to demand quality services that force ULBs to ensure accountability.
- In the long run, users pay rational charges for a financially sustainable service.

For ULBs/Parastatals

- Improved cost recovery and generation of financial resources help sustain, upgrade and expand services on a timely basis to meet the ever-increasing demand.
- Freeing up of financial resources for social services like education, health and nutrition.
- Overall improvement in service delivery, accountability and urban governance.

For State/Central Governments

- Reduced financial dependence of ULBs/parastatals on higher-level governments frees up financial resources for other priority areas of development.
- Ensuring transparent subsidies to needy ULBs requires continued support due to their location or environment disadvantages.

Present Practices in User Charges:

ULBs at present are levying two types of user charges.

In the case of water supply, both fixed flat tariffs and varying volumetric charges linked to the level of consumption are in practice. Water tariffs in certain metros are as follows.

<i>Bangalore</i>		<i>Chennai</i>		<i>Hyderabad</i>	
<i>Year</i>	<i>2005</i>	<i>Year</i>	<i>2006</i>	<i>Year</i>	<i>2007</i>
<i>Domestic</i>	<i>Rupees/KL</i>	<i>Domestic</i>	<i>Rupees/KL</i>	<i>Domestic</i>	<i>Rupees/KL</i>
<i>0-8000 litres</i>	<i>6.00</i>	<i>0-10000</i>	<i>2.50</i>	<i>Ind. Houses</i>	<i>90.00/month</i>
<i>8001-25000</i>	<i>9.00</i>	<i>11000-15000</i>	<i>10.00</i>		<i>8.00</i>
<i>Non-Domestic</i>		<i>Non-Domestic</i>		<i>Non-Domestic</i>	
<i>0-10000</i>	<i>36.00</i>	<i>Up to 500kl</i>	<i>35.00</i>	<i>0-15000</i>	<i>6.00</i>
<i>10001-20000</i>	<i>39.00</i>			<i>16000-30000</i>	<i>8.00</i>

In regard to costrecovery for wastewater management, the general practice is to levy sewerage charges at a flat rate or as a percentage of monthly water charges. The percentage generally varies from 10% to 25% of the monthly water bill.

In the case of solid waste management, a monthly flat tariff framework is generally practiced. Increasing block structures, wherein the relative tariff increases as consumption increases, is generally followed for recovering water charges.

In the case of urban transport, reducing block structures are prevalent, wherein the unit rate decreases with increases in the distance of travel.

3. Steps to implementing the reform

Implementing user charge reforms involves not only recovering cost incurred on provision of service, but also achieving or ensuring economic efficiency (efficient investment allocation and distribution systems), equity and affordability (minimum lifeline rates). The following broad principles/steps should be followed while implementing user charge reforms:

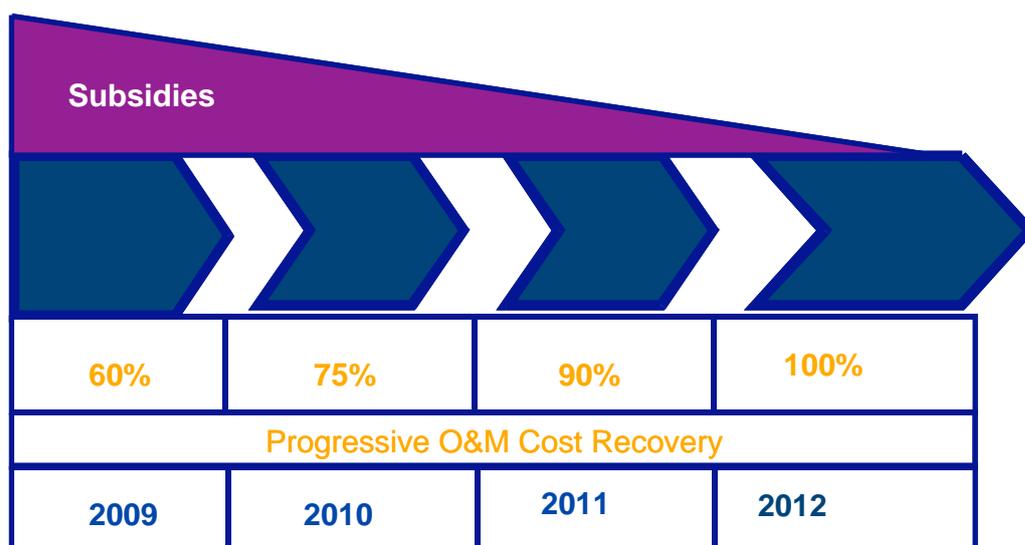
- The first step in implementing user charge reform is to understand the real costs of operations and maintenance for each service. The ULB should attempt to ring-fence all the related costs pertaining to a specific service with clear demarcation in capital and revenue accounts. This permits the identification of the real costs for O&M so that the unit costs, which need to be recovered from the users, can be assessed for the respective service.

On establishing the unit costs of O&M for providing a service, the ULB, as necessary, shall set principles for cross subsidization to ensure, simultaneously, affordability and cost recovery.

- Assess the different user groups’ ability to pay for different services through occasional surveys and establish affordability levels, especially among low-income groups.
- It is always recommended to ensure volumetric pricing wherein the user is charged based on consumption. However, in the absence of measurement systems, a simple telescopic flat tariff system can be followed until the measurement systems are in place. In the case of services like waste management, the user charges are flat tariffs only.
- On determining the tariff structure, including cross subsidies and inflationary trends, the ULB shall prepare a progressive tariff rationalization plan for ensuring recovery of total O&M costs by the year 2012.
- While preparing the tariff rationalization plan, care should be taken to commit to progressively improving efficiencies by reducing losses and improving customer services, which can significantly reduce the tariff impact on the users. Reducing commercial losses primarily by improving management efficiency by way of improving billing and collection systems would require minimal time and capital investment. However, reducing physical losses would require some investments, which need to be planned and budgeted for.
- Tariff increases due to natural inflation shall preferably be automatic and should be implemented at least annually by way of automatic annual indexation. Any increase beyond normal inflation shall be carefully planned, and agreed among the council and with citizen groups.
- If the cost of collecting a charge, say every month, exceeds the amount collected, an alternative charging mechanism shall be determined either by way of integrating with an annual tax or by other means.

4. Setting the timeline

A progressive tariff reform timeline is to be adopted; refer figure below.



5. Measuring Achievement/Outcomes

Measuring the outcome of user charges reform can be achieved by establishing the baseline operating ratio and targets for its progressive improvement and by measuring actual improvement against the targets. The operating ratio is the ratio between total revenue expenditure for operations and maintenance of the infrastructure service and the revenue income. In addition to the operating ratio, the efficiency of billing, collection and account receivables could also be monitored to measure the achievement of this reform. The key outcomes of the user charge reform are:

- Financial self-sustainability of services facilitating availability of resources for other social development sectors.
- Increased recovery of cost of providing services resulting in improved financial resources.
- Availability of adequate capital for meeting demand growth and high quality services.
- Ensuring transparent subsidy structure in user charges for urban poor using the services.
- Equity and fairness of user charge structure not only for the urban poor, but also for all types of consumers of the service.
- Ensuring resource conservation through increased block tariff structures.
- Transparency and accountability in service costs to be recovered through user charges and disclosure of cost information to all stakeholders.
- Efficient management of services with committed plans for reducing losses and improved customer services.