

Rationalisation of Subsidies and Cross-subsidies

Synopsis

- The 1994 COAG Water Reform Framework entrenched the principle of full cost recovery for urban water services and the elimination of cross-subsidies, The Framework further stated that where cross-subsidies are needed to achieve particular social outcomes, they must be made transparent.
- Much has been done to reduce or make explicit subsidies and cross-subsidies within the water industry in line with this Framework
- Despite these achievements, in a number of categories subsidies and cross-subsidies persist or remain hidden. Their existence distorts the market for water and lead to inefficiencies.
- AWA believes that effort needs to be directed to minimising these cross-subsidies and avoiding the emergence of new subsidies and cross-subsidies in future.

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Background

The levying of full cost-reflective prices for water requires the removal of cross-subsidies between users and groups of users (say, between the residential and commercial sectors). While there is justification for the existence of cross-subsidies in certain limited circumstances – for example, to ensure that economically disadvantaged citizens are not prevented from providing for their health and hygiene needs – cross-subsidisation causes market distortion and inefficiency.

The Council of Australian Governments’ Water Reform Framework said:

- (a)(i) *The adoption of pricing regimes based on the principles of consumption-based pricing, full-cost recovery and, desirably, the removal of cross-subsidies which are not consistent with efficient and effective service, use and provision. Where cross-subsidies continue to exist, they be made transparent*
- (ii) *Where service deliverers are required to provide water services to classes of customer at less than full cost, the cost of this be fully disclosed and ideally be paid to the service deliverer as a community service obligation.*

Australian urban water authorities have universally adopted these principles. Associated reforms have moved the industry toward full cost-recovery, consumption-based pricing. Water has become a controllable cost for industry and private consumers, and this has contributed substantially to the reduction in water consumption that has been achieved in urban areas across the country. Furthermore, distortions in the market have been reduced such that water consumption has become more rational. AWA strongly believes these improvements must be protected.

Some cross-subsidies persist, however, and in a number of cases are being extended. Examples include, but are not necessarily limited to:

- Subsidisation of capital projects
- Subsidies and cross-subsidies which distort patterns of development
- Subsidies and cross-subsidies which advantage or disadvantage new users to the advantage or disadvantage of users connected to systems funded through taxation-based mechanisms
- Subsidies or cross-subsidies which advantage or disadvantage one technology or source of supply over another (unless subsidies are provided through a transparent government policy, such as rebates on water efficient appliances)
- Externalities, (unaccounted for costs and benefits accruing to third parties) that represent effective cross-subsidisation between consumers and third parties, often the natural environment.

AWA believes that with the exception of the achievement of specific and costed social outcomes, cross-subsidises should be eliminated wherever possible as they represent distortions in the marketplace that are likely to be economically inefficient. AWA also believes that any move to introduce initiatives that would have the effect of re-introducing cross-subsidies – whether intended or unintended – should be resisted.

Issues

A basic principle of national competition policy has been to remove market distortions that represent economic inefficiency. In the water industry, cross-subsidies became a reform target as the industry and governments recognised the need to open the industry up to competition and to rationalise the use of water which, until that point, was increasing in a linear fashion in line with population growth. Full cost-reflective pricing was a target to be achieved under the 1994 COAG Water Reform Framework and specific note was made of the need to remove cross-subsidies, with exception made only for those cross-subsidies that achieved targeted and transparent social outcomes.

Market distortion also occurs as a result of subsidisation or cross-subsidisation aside from that which formerly existed between categories of user. Part of the rationale for the 1994 COAG reforms was the creation of a framework to equip water service providers with the commercial and regulatory incentives to improve efficiency. Unprecedented efficiency improvements have been achieved by the industry as an outcome of the Framework's implementation. Imperfections remain, however, notably, but not exclusively with regard to the following:

Subsidisation of capital projects.

As described elsewhere in this series of papers, part of the rationale behind the COAG reforms was to provide the correct institutional framework and regulatory environment to encourage commercial behaviour by the water industry. Under this arrangement, the industry itself is responsible for matching supply with demand, either by mitigating demand or extending supply according to market conditions. Recent decisions to increase significantly government funding for specific infrastructure projects has the effect of distorting the planning process and distorting prices as government funding of infrastructure projects without the costs of these projects being reflected in water prices will lead to over-consumption of the resource. In effect, this will also mitigate the effectiveness of the infrastructure being developed. Furthermore, funding of particular projects will, in effect, bias the market against alternative sources of supply that, potentially, might be cheaper than a supply from the anointed source.

Subsidies and cross-subsidies that distort patterns of development.

Ultimately, governments have responsibility for determining which land will be developed or redeveloped. There are cost consequences of these decisions for water supply. In most jurisdictions water service providers are able to cover the full costs of providing infrastructure and in this regard development patterns could be said to be rational with respect to water. However, the generally applied policy of 'postage stamp pricing' can result in consumers in more costly-to-serve areas being subsidised by consumers whose water services can be provided less expensively. Thus, while the initial costs of infrastructure development may be recovered, ongoing operational costs may not be, or may only be through cross-subsidisation by other users. More costly-to-serve areas may therefore be developed ahead of schedule. The long-term impacts of a decision to release an area for development must be taken into account in government planning processes.

Subsidies or cross subsidies that advantage or disadvantage one technology or source of supply over another.

As surface water and ground water sources become more limited in the face of population growth and climate change, attention has been directed to alternative sources of supply. Most commonly these have included rainwater tanks, greywater reuse, industrial scale recycling and desalination. The costs and benefits of these systems will vary according to circumstances, such as demand, frequency of rainfall, land and construction costs and other factors. Some technologies are subsidised by governments as a matter of deliberate policy; rainwater tanks are an example. In other cases, subsidies are implied. For example, governments have taken decisions to acquire land for, build or ease the regulatory process for desalination plants. Where such subsidies exist the potential for market distortion and sub-optimal outcomes may arise. Postage stamp pricing referred to above can also be a barrier to the entry of suppliers utilising alternative, more local sources of water as the price they can provide water services for is more than existing suppliers may charge because of subsidisation of the costs of existing supplies by consumers in cheaper-to-serve areas.

Externalities.

Externalities are costs and benefits that accrue to third parties for which those parties do not pay or are not compensated. An angler fishing downstream of a sewage treatment plant would, for example, be disadvantaged if fish catches declined and no payment was made for these losses. Frequently, this 'third-party' is the environment, the functioning of which may be compromised by over-abstraction or pollution. Externalities represent a subsidy to the system by those negatively affected by its operation and who do not receive compensation (or a reverse subsidy where the third party benefits). The 1994 COAG Framework established the principle of 'full cost recovery' and the NWI states:

That *"The States and Territories agree to...*

(ii) continue to examine the feasibility of using market based mechanisms such as pricing to account for positive and negative environmental externalities associated with water use; and

(iii) implement pricing that includes externalities where found to be feasible"

This outcome has not yet been achieved. Indeed, it is arguable whether significant progress has been made at all. Attention needs to be directed to correcting this anomaly. Regulators, governments and the industry will need to work together to achieve this outcome.

Summary of AWA's Position

The Australian Water Association believes that the general principle of full cost recovery pricing should be rigorously applied. Subsidies that do exist should be explicit and transparent and where required to achieve government social policy outcomes, paid as a Community Service Obligation. AWA does not argue against the need for cross-subsidies to exist to achieve such outcomes, but they must be transparent.



AWA further believes that research is needed to reveal the extent to which hidden subsidies exist (such as those described above with regard to the favouring of technologies or sources of supply). Often it will be the industry's responsibility to carry out this research and submit its findings to scrutiny. Where subsidies arise from planning decisions into which the industry has not had effective input, it will be incumbent upon governments to recognise the market distortions that might arise from planning decisions.

Finally, AWA endorses efforts to internalise externalities to the extent to which such internalisation is economically feasible.

References

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