



# POSITION PAPER

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## Governance

### Synopsis

- A number of States and Territories, and the Federal Government, are actively considering further reform of the Australian Water Industry
- AWA believes that improvements can be made, but that all proposals should be carefully considered to ensure that industry efficiency is maintained and that established frameworks which provide certainty to the industry are not weakened
- AWA further believes that the Federal Government should convene an appropriate national forum of all jurisdictions to consider the practicality of the reforms under consideration.

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### Background

In 1994, the Council of Australia Governments agreed to a Water Reform Framework, which, among other things, specified improvements that would be made to the institutions responsible for urban water service provision.

These reforms required that operational and regulatory functions be separated and that water service providers become more commercially focused. The reforms were intended broadly to improve efficiency of the industry and to rationalise the use of water such that consumers and the environment were protected. The reforms established the frameworks intended to make water companies more responsive to consumers and commercial imperatives, creating more open competition and reducing the influence of centralised planning. Review of performance against the reform agenda was made the responsibility of the National Competition Council operating within National Competition Policy.

A generally consistent approach to water industry governance across the nation resulted, involving the creation of large, integrated state-owned corporatised water service providers with significant outsourcing of the acquisition of capital items and facility management in partnership with the private sector. Operational and regulatory responsibilities were separated in all jurisdictions.

In June 2004 COAG renewed its commitment to a national approach to water management through agreement to a National Water initiative (NWI) overseen by the National Water Commission. The NWI included a commitment to continue urban water reform focused particularly, but not exclusively, on improving water

industry efficiency further, enhancing the functionality and efficiency of the market for water and for water services, and restoring ecosystems damaged through over-allocation.

Concomitant with this development – and accelerating recently – is a view that there has been a ‘planning failure’ by water authorities with regard to the securing of additional water supplies to alleviate water shortage or to cater for growth. This has led to calls for a second wave of institutional reform, variously involving the adoption of:

- Greater competitive procurement of infrastructure and services
- Third-party access regimes to water and sewerage infrastructure
- Some vertical and horizontal disaggregation of service provision, including the separation of distribution and retail services
- Establishment of ‘independent’ entities to direct planning and infrastructure procurement; and
- Reorganisation of State regulators.

Many of these reforms maintain and build on the spirit of the 1994 agreement. However, their implementation must be carefully planned so as not to erode the achievements of the past 15 years. In particular, AWA is concerned that any reforms introduced should be outcomes-focussed; reform for reform’s sake should be resisted. AWA believes especially that:

- Planning must be integrated with service delivery
- Integration between water managers (retailers, distributors, bulkwater suppliers) must be maintained
- Corporate knowledge or capacity could be diminished if disaggregation of the industry is not very carefully planned
- Price signals must not be obscured and prices must continue to be based on the principle of full cost recovery. Externalities should be fully internalised where possible.
- Regulatory regimes must apply equally to the public and private sectors

The AWA recommends a wider debate on future reforms be initiated to avoid these outcomes. Note that in saying that the integration between functions must be maintained, AWA is not arguing for the status quo, but for the maintenance of appropriate interfaces regardless of the institutional arrangements that emerge.

## Issues

### Efficiency improvements as a result of 1994 Reforms

Implementation of the 1994 COAG Water Reform Framework has resulted in huge efficiency gains by the Australian water industry and a significant rationalisation of resource use. It is now inconceivable that water authorities and regulators should ever have been one and the same or that the economic inefficiencies that resulted from cross-subsidisation between user groups should have been allowed to persist. The industry:

- Has a clearer sense of purpose
- Bases decisions on sound commercial practice
- Incorporate sustainability into its business plans and capital and operating budgets
- Is a world leader in strategic asset management, leading to a better understanding of the economic value of its assets and the value of future investment in their maintenance and extension; and
- Prices water according to its true value
- Is exposed to competition

The existence of independent economic regulators as a proxy for market forces in this essentially monopoly industry has also improved the efficiency of the industry and subject its performance to scrutiny. These achievements need to be maintained and improved upon.

### Opportunities for Improvement

The industry should not, and should not be allowed, to rest on its laurels. There are efficiencies that have not yet been realised and governance structures have not always optimised outcomes. Further, a number of developments speak to the need for the industry to maintain its commitment to the intent of the National Water Initiative including reform of institutional arrangements. These developments include:

- Conclusive evidence of human-induced climate change and mounting evidence of climate change effects in Australia which, among other things, will place further limits on the surface water resources available to urban areas
- The need, related to the above, to access all economically accessible and sustainable water resources in an integrated fashion to augment supply or to replace supplies from over-allocated systems
- The availability of new technologies, such as membrane systems, which allow access to new water sources
- The need to ensure that the market conditions are created that will ensure that alternative sources are considered equally with traditional sources
- Allegations of a lack long-term planning for water supply security and, whether or not these allegations are justified, the need to ensure that such planning is carried out
- The need to improve the functionality and efficiency of water trading schemes, including those which would allow trading between urban and rural users
- Opportunities to introduce greater competition, particularly through greater contestability and involvement of the private sector in water service provision, through either increases in partnerships or contracting out of services, or direct involvement in water supply, such as privately developed services based on alternative water sources (e.g. stormwater, recycled water, sewer mining).

### Requirements for Future Reforms

These circumstances force consideration of important questions about water industry governance. For example, if there is to be a multiplicity of service providers, each will need to be regulated consistently. Similarly, if there is to be a variety of sources used, proper pricing signals will need to be set such that the market is not distorted to the disadvantage of one or more of the suppliers, or to users. The deepening of water trading arrangements may necessitate new regulatory structures or, potentially, the disaggregation of distributors, retailers or bulkwater suppliers. The operation and regulation of sewerage systems that are used as sources of water also raises governance questions.

The water industry welcomes scrutiny of existing arrangements to ensure they provide optimum outcomes in future. In this debate, however, the industry seeks institutional and regulatory frameworks that provide the clarity of purpose that supports and guides the industry, including in the management and control of interfaces where the water supply chain has been disaggregated.

AWA's primary interest in urban water services is that they provide: long-term supply security; water quality in line with the Australian Drinking Water Quality Guidelines; environmental protection; ecological sustainability and pricing based on a true valuation of water. Among our concerns with regard to industry restructuring are:

- That dismantling of the large integrated water utilities that exist in all of our major cities and/or the introduction of supply competitors may reduce the ability of the industry to deliver on the outcomes listed above in an integrated, efficient manner
- That unless regulatory regimes are appropriately structured, there will be a lack of accountability for environmental outcomes
- That there should be a matching of the reduction in portfolio ministers' scrutiny of corporatised entities with increased regulatory oversight where these entities are replaced by or compete in the market place with, private companies. In any case, the private sector will want certainty in regulation if it is to invest in the water industry more extensively.
- That corporate memory and the critical mass of skills available in large integrated agencies will be lost if these agencies are disaggregated. This may become a particular problem as new technologies are introduced. The industry and the NWC have previously identified a skills shortage in the industry as an emerging and significant problem. Reforms that exacerbate this problem may be retrograde steps
- That confused or uncertain interfaces between disaggregated entities – say, between retailers and distributors – may lead to suboptimal outcomes and lack of accountability
- That there will be a mismatch between supply and demand if planners and operators are disaggregated, or there becomes a multiplicity of suppliers. Western Australia is, for example, currently considering the creation of an independent water supply planning authority. It is not clear that this will lead to the achievement of least-cost solutions or greater transparency as operational imperatives feed less directly into the planning process
- That separation of planning from service delivery functions could lead to a lack of integration and/or circumstances whereby centralised planning becomes a substitute for appropriately structured markets
- That incorporation of externalities in price will not proceed unless regulatory regimes governing private sector players are well designed. Failure to fully internalise externalities has been cited as one of the areas in which the Water Reform Framework was not significantly achieved.

Reform is encouraged, but not for its own sake. The AWA notes that there are few, if any, international models to follow in this reform process. Whereas reform in the electricity industry has been crafted taking into account successes and failures overseas, and was extensively analysed by the then Industry Commission, there are no precedents for the reforms being discussed with regard to the water industry. This does not suggest that Australia should not be a world leader, but it does hint at the need for caution and diligence.

In particular, it will be important that the industry not be excessively disaggregated such that entities become too small to maintain an effective skills base or that the interfaces between entities becomes less effective, obscuring accountability and effective long-term planning.

It will also be important that Government's recognise that as with any service, there is a risk of market failure due to the low value of the product and low returns on investment. As this is an essential service, Government's will need to accept their responsibility to be a 'provider of last resort' should market failure occur.

## Summary of AWA's Position

AWA is supportive of continued reform in the water industry. The Association believes, however, that the benefits achieved over the past 15 years must be protected and enhanced as they have provided significant value to consumers and the Australian economy. Furthermore, water is essential for life and economic wellbeing; water quality must be protected and supply consistently matched with demand.



While there have been broadly consistent approaches to the structure of the water industry across all States and Territories, AWA respects the right of each jurisdiction to develop its own arrangements. AWA further believes, however, that an important opportunity now exists for the Federal Government to convene an appropriate national forum of the jurisdictions to explore and commission further research on the practicality of introducing competitive pressures, and private sector service provision in the urban water services sector. In all this, the objectives of ensuring water security, safe drinking water quality and ecological sustainability are paramount. The National Water Commission's call for the development of an urban water supplement to the National Water Initiative may be a good place to start this discussion.

## References

Council of Australian Governments Communiqué (25<sup>th</sup> February 1994) *Water Reform Framework*. Environment Australia, Marine and Water Division (see [www.environment.gov.au/water/publications/action/pubs/policyframework.pdf](http://www.environment.gov.au/water/publications/action/pubs/policyframework.pdf))

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