

# Implementing a National Approach to Water Reform

## Background Paper Presentation by Deborah Cope National Competition Council

This paper accompanies the National Competition Council presentation at the 5<sup>th</sup> Annual National Water Conference. It provides more detailed background information on the Council of Australian Governments (COAG) water reforms and their place within National Competition Policy.

### The NCP Program

Australia's National Competition policy reform program, now in its sixth year, is designed to help develop a more dynamic, creative and competitive economy better able to serve the interests of the community. The program builds on pro-competitive reforms that commenced with the *Trade Practices Act 1973*, and focuses on monopoly arrangements.

National Competition Policy (NCP) is part of an important ongoing process of review and reform. This continual process is necessary to ensure that laws, policies and industry structures in Australia continue to evolve in a way that enables businesses to respond flexibly to changing customer needs and new opportunities.

The role of the NCP program in this ongoing process involves:

- extending the reach of the anti-competitive conduct laws in Part IV of the Trade Practices Act to virtually all private and public sector businesses;
- improving the performance of essential infrastructure by implementing nationally co-ordinated reform packages in:

electricity: through the introduction of a fully competitive National Electricity Market by 1 July, 1999 which provides for consumer choice, third party interconnection to transmission and distribution networks and non-discriminatory regulatory arrangements;

gas: through structural reform or ring fencing of vertically integrated transmission, distribution and retail monopolies, the establishment of a national third party code for access to transmission and distribution pipelines and the removal of regulatory barriers to free and fair interstate trade;

water: through a strategic framework designed to create an economically efficient and ecologically sustainable water industry, including pricing reform, structural separation of institutional arrangements, water

allocations and trading, and integrated catchment management and water quality guidelines; and

road transport: through the introduction of uniform national reforms covering heavy vehicle registration, the transport of dangerous goods, driver licensing, vehicles standards, road rules and a consistent approach to compliance and enforcement;

- establishing a legal regime for third party “access” to the services of nationally significant monopoly infrastructure;
- reviewing and where appropriate, reforming all laws which restrict competition by the end of the year 2000, and ensuring that any new restrictions provide a net community benefit; and
- improving the performance of government businesses through:

reviewing the structure of the public monopoly businesses prior to privatising those monopolies or introducing competition into the markets they serve, and ensuring that any regulatory functions held by the public monopoly are relocated;

implementing competitive neutrality principles, including a mechanism to investigate alleged breaches of competitive neutrality policy, to ensure that government businesses do not enjoy unfair advantages or disadvantages arising from their public ownership when competing with private business; and

considering the establishment of prices oversight arrangements to ensure that government businesses with substantial market influence do not overcharge for the services they provide.

Governments also agreed to apply the NCP reform to local governments within their jurisdiction.

## The Need for Water Reform

The water reform program is an important part of this package. It provides for an integrated approach to environmental, social and economic issues. Because of the importance of our water resources, the problems facing this sector and the breadth of the water reform program – implementation of these reforms could do more to benefit the broad community than any other individual NCP measure.

In agreeing to the water reform program in February 1994 COAG considered the report of the Working Group on Water Resource Policy. That report recognised the problems facing the water industry and that a comprehensive and integrated approach was needed to address those problems. The report made the following observations:

*Progress is being made on a number of fronts to reform the water industry and to minimise unsustainable natural resource use. Nonetheless there currently exists within the water industry:*

- approaches to pricing that often pay little regard to differential patterns of consumption among users and involve cross-subsidies which, in turn, can disadvantage industrial and commercial users of water services;*
- the impact of past investment decisions that are now proving to be sub-optimal both from an economic and environmental perspective;*
- major asset refurbishment needs in rural areas for which, in general, adequate financial provision has not been made. This presents governments with a number of challenging decisions in a period of fiscal restraint including whether to increase prices, reduce costs and/or reduce standards of service delivery;*
- limitations on water being employed in higher value uses. At this time there are only limited opportunities to trade water entitlements which contribute to disincentives to water being employed in higher value uses; and*
- institutional arrangements that are in a number of instances less than optimal in that the roles and responsibilities for some bodies in the water industry have not been clearly defined.*

*Numerous policy documents and public reports have also identified a number of issues and deficiencies involving water and the wider natural resource base that require the attention of governments. These include:*

- widespread natural resource degradation which has an impact on the quality and/or quantity of the nation's water resources;*
- while policy and program frameworks are in place to address the natural resource management challenges that exist at present, these policies, practices and levels of private and public investment are not, however, going to halt the process of natural resource degradation, particularly in the Murray-Darling Basin; and*
- whether it is in the Basin, the south west of Western Australia or parts of Tasmania the position has reached the stage where an intensive management effort is required on the part of all jurisdictions to arrest the process of degradation.*

*... Apart from improved environmental outcomes, the strategic framework is expected to result in a restructuring of water tariffs and reduced or eliminated cross-subsidies for metropolitan and town water services with the impact on domestic consumers of water services being offset by cost reductions and more efficient, customer-driven, service provision. Financial assistance for particular consumers may be necessary where*

*cost reductions are not available to offset price increases. In the case of rural water services the framework is intended to generate the financial resources to maintain supply systems should users desire this, allow water to flow to higher value uses subject to certain social, physical and environmental constraints, provide irrigators with a tradeable asset (which could also serve as a useful structural adjustment instrument in some cases) and devolve, where appropriate, operational responsibility for irrigation schemes to local areas.*

*While the need for reform is recognised, the legacy of past investment and policy decisions, particularly in relation to irrigation schemes, means that there are real constraints on the extent and pace of reform in some areas. Because the changes flowing from the framework are extensive and far-reaching in their implications, particularly in rural areas, it is considered that a five to eight year implementation period will be required. Some aspects of the reform packages outlined in the report will require governments to consult widely with the community more generally and private interest groups. (Working Group 1994)*

More recently, the need and support for reform in the water sector has become even stronger.

The South Australian Premier, John Olsen, has made a number of public statements on the importance of water reform and the growing problems South Australia would face if reform does not proceed.

*The sustainability of the River Murray is crucial to the State's future, but also water allocation in the growing regional centres is integral to the viability of our emerging industries in those regions. (John Olsen 2000)*

Similarly, statements from Senator Robert Hill indicate that the Commonwealth Government has also placed a high priority on water reform:

*... the message is clearly that more needs to be done. We must look to change the way we manage the land to improve the quality of this great river.*

*The Commonwealth has taken a lead in this regard with the recent establishment of a high-level cabinet group to examine priorities for natural resource management. A key focus of this group will be the problems facing the Murray-Darling. (Robert Hill 2000)*

A joint report prepared for the Australian Conservation Foundation and the National Farmers Federation stressed that:

*Australia is facing a crisis. Our rural environment and natural resources are suffering. Problems such as salinity, river degradation and pollution, biodiversity loss, and soil degradation, show us that the way our land is used and managed is not sustainable.*

*These environmental issues have significant economic and social dimensions:*

- *the viability of farming (and, thus, our agricultural industry) is being undermined;*
- *rural and regional infrastructure (such as roads, railways, pipelines and buildings) is being eroded; and*
- *industries that depend upon our natural heritage, such as tourism, are being affected.*

*The issues are serious and they impact upon all Australians.*

*The only viable future is one that sustains the economy as well as being ecologically sustainable. It is essential that we find new ways of managing and using our land that are more in tune with the needs of our valuable environment.*

*The solution will require a joint effort by our governments, the public sector and, importantly, the wider community to achieve this future. (ACF and NFF 2000)*

## The Water Reform Program

Full implementation of the COAG water reform package is crucial if these problems are to be addressed. This package is comprehensive covering the urban and rural sectors of the industry, including surface water, wastewater and groundwater. It embraces ecological and economic objectives to ensure water is used sustainably and efficiently. Also, to accommodate the diversity in the industry structures, existing policies and the characteristics of water resources across the country the program was made up of broad reform principles so that implementation can be tailored to meet the needs and characteristics of individual States and Territories.

The water package covers the areas of:

- pricing
- allocating and trading water;
- the environment and water quality;
- institutional structures; and
- public consultation and education.

### PRICING

The strategic framework requires water charges to reflect full cost recovery. Full cost recovery is based on an economic approach and includes the costs of all resources used in directly providing the services and costs from externalities such as salinity and environmental management. Also, where it is practical and cost effective, prices should be based on the amount of water used.

In the urban sector including non-major urban areas such as country towns, reforms include:

- the implementation of two part tariffs for surface and groundwater where cost effective, comprising a fixed cost to cover access to the system, and a volumetric cost component;
- the establishment of internal and external charges for metropolitan bulk water and wastewater suppliers, including volumetric charging, cost recovery and the earning of a positive real rate of return;
- making cross-subsidies transparent or, ideally, removing them when they affect the efficiency of water services; and
- where a service deliverer provides water services to customer classes at less than full cost, this is to be fully disclosed and paid to the service deliverer as a community service obligation.

In the major urban centres, pricing reforms are nearly completed. In some centres this has resulted in increases in some prices and falls in others. Elsewhere, the water service providers have improved their efficiency and there have been significant reductions in prices. The introduction of charges that are based on the amount of water used (two-part tariffs) have given customers a greater control over the size of their water bill and encouraged them to use water wisely.

For example, the cost of water supply per property across Australia in major urban areas has fallen by 19 percent over the last 6 years. Metropolitan Melbourne and other Victorian urban centres have benefited from an 18 percent reduction in water prices from reform, and in Queensland where 17 of the 18 largest local councils have implemented two-part water tariffs, demand for water has been reduced by 20 percent, reducing the need for further water infrastructure developments.

For the rural sector, full cost recovery is to be achieved by 2001 wherever practicable with all subsidies made transparent. Current prices paid for water are likely to rise and, in some cases, have already. However, it has been generally recognised in the past that rural water has tended to be underpriced and this in turn has resulted in water resources being put to less than the best use, contributing to accelerated land degradation, salinity problems and nutrient pollution in some water courses.

Full cost recovery does not require a return on existing rural water assets, although it does require provision for future asset refurbishment or replacement. This means that farmers and businesses will have certainty that their surface water and groundwater sources will be managed sustainably, and headworks and delivery infrastructure can be maintained or replaced in the future. Service providers will also improve the efficiency of their operations because of changes to the way water is managed and delivered, including approaches such as corporatisation and the creation of commercialised State bulk water businesses. These changes will help to offset whatever price increases might occur.

Pricing regimes established under the strategic framework will generate the financial resources to provide for the long term costs of irrigation infrastructure - this will ensure that supply systems needed by irrigators will be on a sounder financial footing. A sharper focus on water industry charging will also help to identify the real value of water and make clear any subsidies or community

service obligations so that decisions can be made about how best to use and protect valuable water resources.

## ALLOCATING AND TRADING WATER

The strategic framework requires separation of water property rights from land title and clear specification of entitlements in terms of water ownership, volume, reliability, transferability and, if appropriate, quality - not only for certainty but also to support an efficient and effective trading system.

In the case of rural water services, it is intended, through a system of tradeable entitlements, to allow water to flow to higher value uses subject to social, physical and environmental constraints. States are giving priority to formally determining allocations or entitlements to water, including allocations for the environment.

Trading in water on a permanent basis, underpinned by clear, well defined, property rights systems, means that farmers will be able to buy and sell water through a market, within the social, physical and ecological constraints of catchments. This will help irrigators to structure their businesses to increase profitability, or assist those who wish to change the use of their farm or leave the industry to do so through the sale of water property rights.

Governments are at various stages in introducing intrastate trading regimes. In those States where trading exists, the benefits are significant. For example, in Victorian irrigation areas, between 1-4 percent of water rights are traded permanently every year, and up to 17 percent are traded on a temporary basis. The benefits of intrastate trade have been estimated at about \$50 million a year in additional agricultural output, mainly in horticulture and dairy.

Trading between states is also being introduced. On 1 January 1998, the Murray Darling Basin Commission (MDBC) commenced a trial interstate water trading project. Initially the trial is to be limited to the permanent sale and purchase of high security water by private diverters in the Mallee Region in NSW, Victoria and South Australia.

Water trading gives farmers greater flexibility to alter crop types to maximise farm income. The benefits farmers get from irrigation vary greatly between different types of crops. For example, the same megalitre of water that produces a tonne of rice may provide five or twenty times the financial return when applied to wine grapes. At present more than 40 percent of irrigation water goes to low value pasture activities. It is clear that water transferred out of broad acre cropping and into stonefruit, for example, is going to boost overall rural profitability. There is not infinite scope for doing this of course. But the substantial increase in wine exports in recent years gives an indication of what can happen when scarce water is used in those irrigation industries which generate the highest returns.

## THE ENVIRONMENT AND WATER QUALITY

The Framework requires environmental reforms such as recognising the environment as a legitimate user of water, establishing entitlements for the

environment on stressed or overallocated rivers as a priority, and improvements in water quality.

Environmental allocations are to be determined on the basis of the best scientific information available and will have regard to the water needs required to maintain the health and viability of river systems and groundwater basins. The NSW Government, for example, has announced two water reform packages to target clean, healthy and productive water use on stressed rivers by ensuring a better balance between water users and the environment. Queensland has undertaken Water Allocation and Management Planning (WAMPs), based on basin-wide hydrological modelling to make decisions concerning future water use of significant river systems, including explicit provision of water for the environment.

The strategic framework also provides that where significant future irrigation activity or dam construction is contemplated, robust appraisal processes be undertaken to determine that the investment project would be economically viable and ecologically sustainable.

The strategic framework recognised the importance of the health of water for country towns and cities alike, calling for reform to improve the environment and national water quality. Included is a National Water Quality Management Strategy (NWQMS) to sustain usage and the environment by protecting and enhancing water quality in a way that meets each jurisdiction's needs. The strategy contains guidelines to raise national drinking quality standards to 1987 World Health Organisation standards. Victoria, for example, will spend \$1 billion to ensure that virtually all country towns have good clean water to international standards by 2001.

## INSTITUTIONAL STRUCTURES

Institutional reforms cover a range of issues including administrative arrangements and decision making processes within governments, the pursuit of integrated catchment management approaches, devolution of management of irrigation areas to local bodies and a commercial focus for service delivery organisations. To promote a commercial focus, governments have a range of policy options at their disposal, ranging from corporatisation and contracting out services to privatisation.

The strategic framework requires that governments develop administrative arrangements that ensure an integrated approach to natural resource management. A complementary requirement is the adoption of integrated catchment management approaches in consultation with local government and the community.

Functions relating to standard setting such as monitoring of water quality standards or guidelines, regulation of water services and natural resource management functions are to be separated from activities relating to service provision. Aligning organisational structures with objectives means that separate bodies can be provided with clear and non-conflicting roles and more transparent accountability mechanisms. This will allow organisations to focus on



core business and in the case of service deliverers leads to improved customer service and greater efficiency.

Constituents are to be given a greater degree of responsibility in the management of irrigation areas through operational responsibility being devolved to local bodies where an appropriate regulatory framework has been established. This means that local users, such as irrigators, can expect to have a more direct say in the type and level of service that they want, linked to the price they are willing to pay. Devolution is important as it means that irrigators will have a vested interest in seeing that their business runs as efficiently and effectively as possible - the costs are minimised and services are streamlined to be responsive to business needs.

## PUBLIC CONSULTATION AND EDUCATION

The scope of reform to the water industry in Australia is extensive. It is complex and requires water users to fundamentally challenge previous assumptions regarding their right to use water and the price that should be paid for water.

Given these considerations, public education and consultation are essential if the long-term benefits of water reform are to be realised. As with other measures of National Competition Policy, the failure to effectively communicate the need for change and consult on implementation can undermine the reform process.

The strategic framework commits States and Territories to public consultation, particularly in relation to pricing reforms and water allocation and trading. It further commits States and Territories to develop public education programmes in relation to water use and the need for, and benefits from, reform. It also requires development of extensive resource materials on water resources for use in schools.

In Tasmania, a *Waterwatch* programme is included in the education syllabus. It includes a field handbook and professional development for teachers involved.

In the Northern Territory an interactive CD Rom has been developed to assist in school education, employing characters such as '*Wurgle the Waterdrop*' to introduce students to the principles of water conservation.

## Role of the National Competition Council

The National Competition Council was created in 1995 to oversee implementation of NCP. The Council's roles extend to:

- Assessing Governments' progress on competition policy reform;
- Making recommendations to Government on access to significant infrastructure services; and
- Other work on competition policy as agreed by a majority of the stakeholder governments.

For water reform the Council's role in assessing Government's progress is the most directly relevant. The Council completed its first assessment of governments' progress on competition policy reform in July 1997 (this first assessment did not include water reforms), the second assessment was finalised in July 1999 and the third assessment is due in July 2001.

Under NCP the Commonwealth agreed to make payments to the States and Territories for implementing the reform package. These payments recognise that NCP reforms provide dividends not just to the whole community, but also to Commonwealth revenues. The payments are an economic dividend paid by the Commonwealth to States and Territories in return for their investment in NCP reform. They also ensure that some of the tax revenue gains from reform accrue directly to each responsible government as a fiscal incentive.

Satisfactory progress against the NCP obligations is a prerequisite for States and Territories to receive these payments: without reform implementation, there can be nor reform dividends to share. The Council's assessments of State and Territory progress against the NCP obligations include recommendations to the Commonwealth Treasurer on the NCP payments. Where governments don't invest in reforms in the public interest, reductions in NCP payments may be recommended.

## Progress in Water Reform

Water reform was not part of the 1997 assessment. Governments had commenced work on implementing the reforms but it wasn't until 1999 that the Council was required to fully review the extent of implementation of the reforms.

Significant progress had been made but Governments also recognised that it was a large, complex and difficult reform program. In January 1999, representatives of the High Level Steering Group, Committee for Regulatory Reform, Australian and New Zealand Environment and Conservation Council and the National Competition Council met to consider adjustments to the water reform program and the implementation timetable.

The Prime Minister, in his letter to Premiers and Chief Ministers seeking endorsement of the recommendations noted that the changes, which recognise the complexity of the implementation task, will result in an extension of the timetable for implementation of the environmental allocations and water trading reforms from 1998 to July 2001. This is balanced, however, by a more rigorous specification of the commitments and implementation path for allocations to stressed rivers and trading arrangements.

## Second Assessment 1999

This assessment demonstrated the commitment of governments to the water reform program. In most respects, the reform commitments had been met or significant progress had been achieved.

Where the Council was concerned that a reform commitment was not met, the State or Territory identified a path forward in all cases. The Council was satisfied that Victoria and the ACT sufficiently met reform commitments. It

recommended that supplementary assessments be undertaken in respect of various matters for all other States and Territories.

The second assessment focussed on: urban water pricing; the approaches to determining the economic viability and economic sustainability of new investment proposals; the establishment of timetables for providing environmental allocations in stressed river systems; and establishing frameworks to allow for appropriate institutional structures and the allocation and trading of water.

## The Task Ahead

The 1999 assessment provided an opportunity to recognise the successes of States and Territories in implementing water reform. In addition, jurisdictions had committed to implementing outstanding reform commitments.

While much of the focus was on the urban water industry for the 1999 assessment, in 2001 focus will turn to rural water services, providing a better balance of water allocation including water for the environment and improving the quality of water for both users and the environment.

The Council will continue to adopt a co-operative and consultative approach when working with States, Territories and other stakeholders to complete any remaining 1999 commitments and progress commitments that will be assessed in 2001.

Overall, the Council understands that there are no easy answers in water reform and is under no illusions as to the magnitude of the task States and Territories set themselves in agreeing to the reform framework. However, change is necessary and implementing the agreed reforms is leading to results.

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