Institutional reform issues

Introduction

All states and territories have agreed that, for the purposes of meeting institutional reform commitments specified in the CoAG water Framework, separation of ministerial responsibility for the water service provider on the one hand and resource management, standard setting and regulatory enforcement (hereinafter generally referred to as *regulation*) on the other is an acceptable but not the only acceptable form of separation.

This paper considers some of the reasons for clear delineation of service provision and regulatory functions in the water industry. It considers the types of institutional arrangements that may meet the commitment to separate functions in the CoAG water resources policy, and the characteristics of those arrangements. Also considered is the related matter of public education by service providers.

Components of the water industry

A water service provider sells water and wastewater services to customers. Service provision functions include some or all of the following: storing water; treating water; delivering water; collecting wastewater; disposing of wastewater; billing and other dealings with consumers; and advising consumers of water services that are provided.

Standards for service provision encompass the parameters within which water service providers operate. Standards include: the quality of water delivered (including meeting relevant health standards) and effluent disposed; water infrastructure standards; resolving customer complaints, agreeing on customer charters and advising of customer rights; and setting licence conditions.

Resource Management includes: allocating water including determination of the needs of the environment; managing water flows; integrated catchment management; and public education about the need to use water wisely.

Regulatory enforcement includes mechanisms such as monitoring, analysing and assessing performance to ensure that service providers comply with standards and resource management requirements.

Why regulation is important

The Utility Regulators Forum discussion paper, *Best practice utility regulation* (the URF paper) notes that the main justifications for regulation of utilities are to reduce or manage the risk associated with

market failure or to achieve certain social objectives, such as providing services in remote areas or reducing risks to public health and safety.

Proper institutional arrangements foster efficiency and competition, promote outcomes that are in the public interest and protect important environmental, community and consumer values. Institutional arrangements provided for in the CoAG Framework have at their heart the removal of conflicts of interest. The reforms introduce role clarity and provide an ongoing assurance of service assessment, review and improvement. Service providers are able to focus on their core business while subject to open and transparent accountability mechanisms.

Failure to provide for rigorous institutional arrangements has implications for matters such as: the transparency of decision making and regulation; the independence of regulators; the consistency in treatment of government and non-government service providers; and the services provided including price and quality.

Regulation and service provision in the water industry

Unlike other utilities, where many competing service providers remain in private hands or have been privatised, state and territory governments remain the major and often the only provider of water services to households and rural, regional and metropolitan businesses. Governments are also responsible for regulation of the water industry, particularly resource management and service standards. This is usually achieved through departments and statutory authorities.

There are a range of reasons for regulating the provision of water and wastewater services that span social, environmental and economic concerns. For example, applying the justifications for regulation identified in the URF paper to the water industry:

- the need for regulation of standard setting stems from factors such as there is almost invariably only one service provider of water utility services, consumers may not be able to get sufficient information to make their own assessment of the services provided, and because water is an essential utility service. This combines twin regulatory justifications of market failure and social objectives; and
- regulation of water service providers deals with issues such as whether a water harvesting infrastructure project is consistent with efficient and sustainable outcomes. Such regulation determines how much water should be allocated or extracted from a water system and who should receive that water. These issues are associated with achieving water use that maintains environmental, social and economic objectives.

Because of the concentration of service providers in the hands of government, transparent, independent, consistent and accountable arrangements between the service provider and the government's regulators are important. Any arrangement regulating service providers should at the very least ensure that conflicts of interest are identified and addressed. This provides the greatest potential for the benefits of rigorous institutional arrangements to flow to water users, communities and the environment.

Conflicting responsibilities

The reforms agreed to in the CoAG Framework directly or implicitly recognise that, where there is unclear or incomplete separation between responsibilities for service provision and regulation:

- there is an overlap in various functions and obligations and this provides an environment for conflicts of interest;
- there is a divided focus between the commercial imperatives of the service provider and the duties and responsibilities of the regulators; and
- there is an incentive for regulation to favour the government service provider over other actual or potential providers (for example, non-government or local government).

If there is an inadequate degree of separation, other participants in the industry may doubt whether the regulator treats them in the same manner as government service providers. Community groups including environmental advocates and business organisations will question the independence of the regulator and raise concerns about the transparency of decision making. Consumers may be concerned that water quality, pricing and domestic connection standards are the responsibility of the body or person who is also responsible for providing the service.

The failure to provide for adequate separation of service provision and regulatory roles may result in the same person or body setting dividend targets for a service provider and also setting prices charged to customers. The failure to provide for adequate separation of resource management and service provision may result in the same body determining the amount of water to be allocated from a water system and to whom it should be allocated, while also having responsibility for the competing water service provider.

The Council's assessment of institutional arrangements

Institutional arrangements will be assessed with regard to matters relevant to individual states and territories including the size of the

jurisdiction, the manner of service provision and all relevant water industry institutions. The focus of the assessment will be to ensure that potential and actual conflicts of interest are addressed to promote the best outcomes from institutional reform.

Separation of service provision and regulatory responsibilities should provide for rigorous ringfencing arrangements. In addition, separate organisations should be responsible for service provision (such as a government-owned or private corporation) and regulation (such as a government department or statutory authority). These arrangements alone, however, will not be sufficient. The degree of transparency, regulatory independence and accountability will provide relevant touchstones.

What follows are a number of examples which in the Council's view meet reform commitments. This is not an exhaustive list.

Separate Ministers

The Council's view is that separate ministers for service provision on the one hand and regulation on the other would facilitate good institutional arrangements.

Many of the concerns that arise where the state is the primary service provider can be addressed by separating out conflicting Ministerial responsibilities. If a Minister is responsible for providing water services, and another Minister is responsible for the departments or agencies that regulate service providers, there are clear and non-conflicting roles for respective service provider and regulatory Ministers.

Ministerial separation is a solid foundation on which sound institutional arrangements can be built.

Regulator reporting publicly

Concerns about achieving robust institutional separation may be met by a regulator being empowered to publicly report on matters. This is particularly relevant where the Minister does not follow the regulator's recommendations. A further requirement that the Minister also make public reasons for a decision that are against the regulator's recommendations increases transparency and accountability.

An example of this is where the regulator is empowered to report to Parliament. This provides the Parliament and public the opportunity to scrutinise the recommendation and Ministerial decision. Members of Parliament are able to accept representations from electors as to the Minister's or regulator's view and raise these matters in the Parliament. The Parliament, to whom the Minister is accountable, is able to scrutinise the Minister's and regulator's actions.

Regulator's decision binding on the Minister

A regulator may be empowered to make decisions that bind the Minister, or the Minister may be required to appeal to an independent arbitrator or tribunal to overturn the regulator's decisions. This provides for a strong degree of independence for the regulator.

Where an appeal right is provided there is separate, transparent and independent scrutiny. A Tribunal decision will also add a further degree of certainty and predictability to future Ministerial and regulatory determinations.

Procedural arrangements

Where several Ministers are responsible for the service provider and one Minister has conflicts due to regulatory responsibilities, separation may be achieved by arrangements such as the corporatisation of the service provider, the Minister declaring conflicts and, in appropriate circumstances, the Minister absenting themselves from discussions. These arrangements may also be appropriate for regulatory determinations. For example, where regulatory decisions have an impact on the financial or other material interests of a water service provider which is also the Minister's responsibility.

Public education by service providers; a related matter

In its second tranche assessment report, the Council noted its concern over water service providers being responsible for education on the need to conserve water.

- The Council noted that there is a potential conflict in the service provider being responsible for determining the level of ongoing public education on water conservation when it has a financial interest in increased water consumption and profits from customers with greater water usage. Where a service provider is used by government to provide education to the public or its customers the Council will look for this potential conflict to be effectively addressed. The Council is interested in information on measures used by jurisdictions to address this issue.[1]

Separating service provision from regulation in the water industry - relevant reports

The following reports provide clear justifications for the separation of water service provider from regulation. They all demonstrate the need for rigorous institutional arrangements.

[1] This information could include advice of instances where programs are offered by service providers as 'good corporate citizens' or where a purchaser/ provider split is in place.

As an introduction, it is noted that water service delivery is generally undertaken by state owned corporations or authorities, and each water provider is generally without a direct competitor. Examples include:

- State Water (New South Wales);
- Victoria (the various Metropolitan, Non-Metropolitan Urban and Rural Water Authorities);
- State Water Projects (Queensland);
- Water Corporation (Western Australia);
- SA Water (South Australia);
- River and Water Supply Commission (Tasmania);
- ACT (ACTEW); and
- the Northern Territory (Power and Water Authority).

The existence of one provider means that institutional arrangements need particular scrutiny to ensure that they meet the various needs of consumers and communities.

The CoAG Water Resource Policy

The Report of the Working Group on Water Resource Policy to the Council of Australian Governments (February 1994) noted, at clause 3.9 as follows:

> *'While some jurisdictions are moving to change the institutional arrangements surrounding their water industries … there is still a deal of overlap in some areas in relation to the trustee for the resource, establishing and enforcing regulatory requirements and service delivery. In a first best or ideal world it would be desirable that each of these functions be undertaken by separate entities. The alignment of organisational structures with objectives means that separated bodies can be provided with clear and non-conflicting objectives and more transparent accountability mechanisms. This would enable organisations to focus more on their 'core business' and lead, particularly in the case of service deliverers, to improved customer service and greater efficiency'.*

Clauses 6(c) & (d) of the CoAG Framework therefore agreed that :

> *'In relation to water resource policy, the Council agreed … in relation to institutional reform: … to the principle that, as far as possible, the roles of water*

resource management, standard setting and regulatory enforcement and service provision be separated institutionally; that this occur, where appropriate, as soon as practicable, but certainly no later than 1998;'.

The Hilmer Report

The Hilmer Report considered the question of reforming public monopolies, including the separation of regulatory and commercial functions. The report noted that:

> *'In a competitive environment, such a dual role creates a potential conflict of interest between advancing the commercial interests of the enterprise and advancing wider public interests through the exercise of regulatory powers, presenting opportunities for incumbents to misuse control over regulatory standards to frustrate the actions of actual or potential competitors. The rationale for separating regulatory and commercial functions of a public enterprise is widely appreciated….'*
>
> *Where the regulatory function is to continue to be exercised through a government agency other than the incumbent, there is still a need to consider the potential for conflicts of interest. For example, placing these responsibilities in a government department may create concerns that regulatory discretion's will be exercised to the benefit of government owned business – and hence government revenues – rather than in a more even-handed manner. A technical regulator at arm's length from the government will generally be preferred'. (Hilmer et al 1993 pp. 217, 218)*

The report's recommendations included that, before competition is introduced to a sector traditionally supplied by a public monopoly, any responsibilities should be removed from the monopoly; '*the location of regulatory functions should place special weight on the need to avoid conflicts of interest*'. The report notes that vetted voluntary arrangements or independent technical regulation may be appropriate.

The Hilmer report recommendations are reflected in clause 4(2) & (3) of the Competition Principles Agreement (CPA). For example, Clause 4(2) provides:

> *'Before a Party introduces competition into a sector traditionally supplied by a public monopoly, it will remove from the public monopoly any responsibilities*

for industry regulation. The Party will re-locate industry regulation functions so as to prevent the former monopolist enjoying a regulatory advantage over its (existing and potential) rivals'.

Other Reports

The CoAG Taskforce on Water Reform's 1996 report, Generic National Milestones for Actions to Implement the CoAG Strategic Framework for Water Reform noted that the *Spirit of Intent* for institutional role separation was: '*To minimise the conflict of interest in the roles of regulator, manager and service provider and establish a structural basis for the competition principles*'. Milestones identified included: '*Demonstration of adequate separation of roles to effectively minimise conflict of interest in a way which suits the specific needs of the jurisdictions*' and that the reforms provide an appropriate structural and administrative response to the Competition Principles Agreement.

The ARMCANZ/ANZECC policy position paper Water Allocations and Entitlements – a National Framework for the Implementation of Property Rights in Water noted, in canvassing market-friendly water entitlement structures and institutional arrangements (Part 3.2), that clarification of institutional arrangements and responsibilities has been an important driver in water industry reform.

Principle 7 of the ANZECC National Principles for the Provision of Water for Ecosystems (1996) provides that '*Accountabilities in all aspects of management of environmental water provisions should be transparent and clearly defined*'. The principles note that the authority responsible for managing an environmental water provision or allocation should be clearly defined and accountable to both government and the community.

Recommendation 11 of the ARMCANZ policy position paper Allocation and Use of Groundwater, a National Framework for Improved Groundwater Management in Australia (1996) provides for State and Federal agencies to develop and implement organisational arrangements and processes which specifically eliminate conflict of interest situations in groundwater assessment and management. The paper notes that commercial/sectoral interest conflicts, internal 'self assessment' conflicts and funding conflicts can occur. Conflicts of interest can be minimised through arrangements including separation of commercial and other functions and ensuring water management decision making processes are carried out in an open and public way.