Hon Nanaia Mahuta, Minister of Local Government

Proactive release of Cabinet material about investing in water infrastructure to accelerate reform and support economic recovery post COVID-19, 3 June 2020

The following documents have been proactively released:

3 June 2020, DEV-20-MIN-0099 Minute: Investing in Water Infrastructure to Accelerate Reform and Support Economic Recovery Post-COVID-19, Cabinet Office; and


Some parts of this information would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act). Where this is the case, the relevant sections of the Act that would apply have been identified. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to Redaction Codes:

- 9(2)(f)(iv) – maintain the constitutional conventions for the time being which protect the confidentiality of advice tendered by Ministers of the Crown and officials

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Investing in Water Infrastructure to Accelerate Reform and Support Economic Recovery Post-COVID-19

Portfolio    Local Government

On 3 June 2020, the Cabinet Economic Development Committee:

Background

1 noted that on 28 January 2020, the Cabinet Business Committee considered reforms to local government water service delivery and funding arrangements, agreed to support local authorities to make voluntary changes, and agreed to set a one-year deadline for demonstrating progress [CBC-20-MIN-0006].

2 noted that since those decisions were made, COVID-19 has exacerbated the three waters challenges facing the local government sector and, without support:

   2.1 investment will not occur to the levels required;
   2.2 the condition of infrastructure will continue to decline;
   2.3 sector capability, capacity and funding issues will remain;
   2.4 there could be negative implications for public health and environmental outcomes;

3 noted that to respond to, and recover from, COVID-19, opportunities for investment need to be identified, such as water infrastructure, to cushion the blow and help to kick-start the economy, and the approach to restructuring water services needs to be reconsidered;

4 noted that in April 2020, the Ministers of Local Government, Health, Environment, Infrastructure, Rural Communities, Conservation, Climate Change, Commerce and Consumer Affairs, and Urban Development (Three Waters Ministers) discussed opportunities to support economic recovery post COVID-19, and identified a dual approach of:

   4.1 stimulating investment, to assist economic recovery through job creation, and maintain investment in water infrastructure renewals and maintenance; and
   4.2 fundamentally reforming the water service delivery sector, to realise significant economic, environmental, public health, and other benefits over the medium to long term;
agreed to proceed with a three-year programme for reforming three waters service delivery arrangements, to be delivered in parallel with an economic stimulus package of Crown investment in local authority water infrastructure, which together could:

5.1 protect or create at least 11,000 jobs, and generate an estimated $3.9 billion in additional GDP;

5.2 ensure planned investments in water infrastructure continue;

5.3 incentivise the local government sector to support the reform agenda;

agreed that provision of the economic stimulus is conditional on local authorities opting in to service delivery reform and, specifically, the creation of a small number of multi-regional water service providers;

agreed that there be further discussions with Three Waters Ministers and local government about the exact number and boundaries of the multi-regional water service providers, and that final decisions would be based on the following factors:

7.1 achieving scale benefit, including at least one very large urban centre within each entity, to ensure the full benefits of scale are achieved through a larger network and population base;

7.2 communities of interest;

7.3 relationships with other jurisdictional boundaries, including catchments;

agreed that the following high-level design objectives would be reflected in the new multi-regional models for water service delivery:

8.1 financial sustainability, affordability, and resilience;

8.2 effective, efficient, and reliable services;

8.3 enable an effective, efficient regulatory system;

8.4 minimise the negative impact of reform, where possible;

agreed that the new multi-regional models for water service delivery would include the following safeguards:

9.1 mechanisms that provide for continued public ownership of water infrastructure, and protect against privatisation;

9.2 mechanisms that provide for community input and local service delivery;

agreed in principle that, subject to discussions with local government and detailed policy design work, that the new multi-regional water providers would be:

10.1 statutory, asset-owning entities, with commercial disciplines, and a competency-based board;

10.2 owned by local authorities, as shareholders, but with sufficient legal separation to ensure there are no restrictions on the entities’ ability to borrow on similar lines to other utilities;
noted that a number of related matters would need to be explored through further policy development and design work, including:

11.1 the nature of local government shareholding arrangements;
11.2 the potential for the Crown to be a shareholder, and for other investors in the new entities;
11.3 funding and financing arrangements;
11.4 mechanisms that provide for local community input and local service delivery;
11.5 the nature and extent of the legislative framework that would be required to regulate the new entities, including economic regulation and mechanisms to protect consumer interests;
11.6 the scope of the new water entities’ remit, particularly regarding the provision of stormwater services, and drinking water and wastewater services that are currently the responsibility of private/community suppliers;
11.7 the potential use of instruments like a government policy statement to guide/direct the new water entities;
11.8 the options for addressing the funding challenges facing Crown water infrastructure providers within the context of these reforms.

noted that there will also need to be further work to consider and address Treaty-related rights and interests, including in the design of the new water entities, and a strategy for engaging with iwi/Māori is being prepared to inform this work;

invited the Minister of Local Government to report back in:

13.1 with further advice on the matters referred to in paragraphs 7 to 12 above, and on the allocation of funding to rural drinking water suppliers as referred to in paragraph 25 below;
13.2 with detailed policy proposals relating to the matters referred to in paragraphs 7 to 12 above, to inform the preparation of legislation to give effect to the reforms during 2021;

noted that an initial work programme has been identified to implement the proposed reforms to water service delivery arrangements, including the following workstreams:

14.1 stakeholder engagement and communications;
14.2 policy, legislation, and guidance;
14.3 structuring the new multi-regional water entities;
14.4 establishment and implementation;
14.5 project management, reporting, and programme development;

noted that, subject to agreement to funding as outlined below, the Department of Internal Affairs will lead the service delivery reform work programme, working closely with other agencies including The Treasury, Ministry of Business, Innovation and Employment, Ministry of Health, and Ministry for the Environment, and with sector representative bodies;
agreed that governance for the service delivery reform programme be provided by the group of Three Waters Ministers, as referred to in paragraph 4 above;

Engagement with the local government sector

noted that, while gaining support from local government is vital, it is important to move quickly to develop agreements with the sector, shape the broad reform agenda, and to undertake detailed policy design work, and that it will not be helpful to enter into protracted negotiations with the sector before this work can begin;

noted that officials from the Department of Internal Affairs, The Treasury, Local Government New Zealand, and the Society of Local Government Managers will form a joint working group, which will prepare:

18.1 an initial high-level agreement on how local government will work with government on the service delivery reform and investment stimulus agenda, in June 2020;

18.2 a more detailed agreement (memorandum of understanding) that councils across New Zealand would have the opportunity to opt in to in August 2020;

18.3 advice on the policy matters referred to in recommendations 7 to 11 above, including the suggested number and structure of the new multi-regional water entities, by 1 December 2020;

agreed that:

19.1 initial funding from the economic stimulus package be released to those councils that agree to the memorandum of understanding referred to in paragraph 18.2 above, in August 2020, provided that a sufficient number of councils opt in to make relevant new service delivery entity viable;

19.2 councils that do not opt in at this point would still be able to do so at a later date, but would not receive the first amount of stimulus investment;

noted that once agreement has been reached with councils, it is anticipated that Crown Infrastructure Partners would have an oversight role in relation to the allocation and use of the economic stimulus, in accordance with the agreements;

noted that there will be continued engagement with local government, including direct engagement with councils, and an engagement strategy will be developed to guide this work;

invited the Minister of Local Government to report back on progress with sector engagement in [9(2)(f)(iv)]

Financial implications

noted that it will take significant resources to administer and implement the complex service delivery reform and investment programme described above, incentivise and enable the local government sector to support the reforms, address infrastructure deficits, and provide an appropriate economic stimulus;
26 agreed to invest $51.410 million over four years to provide ongoing funding to the new Water Services Regulator, Taumata Arowai, the new Crown agent responsible for overseeing the drinking water regulatory systems and the delivery of a small number of centralised wastewater and stormwater functions, and to cover the costs associated with monitoring this entity;

27 agreed to increase funding in Vote Internal Affairs to meet the costs associated with the three waters reform programme, and the ongoing operations of Taumata Arowai;

28 noted that the funding to deliver the three waters reform programme will support local government recovery from COVID-19 and contribute to the revitalisation of the economy;
agreed to add the following new category to the multi-category appropriation ‘Local Government Administration’ to support the new Crown agent, Taumata Arowai:

<table>
<thead>
<tr>
<th>Title</th>
<th>Type</th>
<th>Scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taumata Arowai</td>
<td>Non-departmental Output Expense</td>
<td>This category is limited to supporting Taumata Arowai in meeting its statutory responsibilities to regulate New Zealand’s water supplies.</td>
</tr>
</tbody>
</table>
Janine Harvey
Committee Secretary

Present:
Hon Kelvin Davis
Hon Grant Robertson (Chair)
Hon Phil Twyford
Hon David Parker
Hon Nanaia Mahuta
Hon Stuart Nash
Hon Iain Lees-Galloway
Hon Jenny Salesa
Hon Damien O’Connor
Hon Kris Faafoi
Hon Shane Jones
Hon Willie Jackson
Hon James Shaw
Hon Eugenie Sage

Officials present from:
Office of the Prime Minister
Officials Committee for DEV
Investing in water infrastructure to accelerate reform and support economic recovery post COVID-19

Proposal

1. This paper proposes a three-year programme for reforming three waters service delivery arrangements, which would be delivered in parallel with an economic stimulus package of Crown investment in water infrastructure.

2. The proposed approach is designed to support economic recovery post COVID-19, and address persistent systemic issues facing the three waters, through a combination of:
   2.1 stimulating investment, to assist economic recovery through job creation, and maintain investment in water infrastructure renewals and maintenance; and
   2.2 fundamentally reforming the water service delivery sector, into large scale multi-regional providers, to realise significant economic, public health, environmental, and other benefits over the medium to long term. (This would be an ‘opt in’ reform programme, in which councils that choose to participate would be eligible for stimulus funding, provided there are sufficient numbers of councils to provide entity scale.)

3. The paper seeks agreement to:
   3.1 the overall approach to the reform and investment programmes;
   3.2 the scope, nature, timing, and key components of the service delivery reforms;
   3.3 the appropriation of funding of \((2)\) to resource the work programme, both within the Department of Internal Affairs, and across 67 territorial authorities and supporting sector organisations;
   3.4 establish a tagged operating contingency of up to \((2)\) over three years to provide for an economic stimulus package of Crown investment in water infrastructure, and reform programme costs, comprising:
     3.4.1 an early injection of \((2)\) to support the local government sector to maintain planned investment and asset quality in the face of significant declines in council revenue (the release of which would be conditional on sector support for service delivery reforms);
     3.4.2 a second, more scalable stimulus of up to \((2)\) to support large-scale asset replacements, and the bringing forward of ‘no regrets’ investment in the latter half of the reform period;
     3.4.3 programme reform and support costs of \((2)\), including funding to enable the local government sector to participate in the service delivery reform process, and to conduct the highly complex legal, accountancy, and due diligence work associated with implementing the reforms (given 67 councils would be involved).
4. Appendix A provides a two-page overview of the proposals and reform timetable.

5. This paper also seeks agreement to investment of $51.410 million over four years to provide ongoing funding to Taumata Arowai, the new Water Services Regulator, and for the monitoring work associated with this Crown agent.

Relation to Government priorities

6. The proposals in this paper relate to the Government’s response to COVID-19. The initial phases of economic stimulus directly support Wave 2: ‘kickstarting the economy’. Later stages of the stimulus, and the service delivery reform programme, support Wave 3: ‘reset and rebuild’. Any short-term stimulus will also support local authority balance sheets, which is well aligned to Wave 1: ‘cushioning the blow’.

7. The proposals also relate to core components of the Three Waters Review, reforming water service delivery and funding. In April 2019, it was agreed that the Three Waters Review is a Government priority. In January 2020, we acknowledged that there is a strong case for change to service delivery arrangements, and agreed to support local authorities to make voluntary changes in the first instance.

8. The dual approach I am proposing in this paper is designed to address the persistent systemic issues and infrastructure deficits identified throughout the Three Waters Review. We have an opportunity to achieve transformational changes to three waters services, to deliver significant long-term benefits to consumers and the economy.

Executive summary

9. A lot has changed in the past three months. COVID-19 has exacerbated the three waters challenges already facing the local government sector. Many councils and communities will struggle to respond to these challenges. Without support, investment will not occur to the levels required, and the condition of infrastructure is expected to continue to decline as councils prioritise other areas of investment. Sector capability, capacity and funding issues will remain. Progress with voluntary service delivery reforms is unlikely to be made at the level and pace required.

10. To respond to, and recover from, COVID-19 we need to identify opportunities for investment, such as water infrastructure, to help to kick-start the economy. We also need to reconsider the approach to restructuring water services.

11. During April 2020, Three Waters Ministers\(^1\) met to discuss three waters infrastructure investment and reform opportunities, in light of the COVID-19 situation, and to agree a way forward. This paper reflects these discussions, and the consensus that emerged.

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\(^1\) Three Waters Ministers include the Ministers of/for: Local Government; Health; Environment; Infrastructure; Rural Communities; Conservation; Climate Change; Commerce and Consumer Affairs; and Urban Development. The Ministers of Finance and Treaty of Waitangi Negotiations also received material relating to the meetings that were held in April 2020.
12. I am seeking agreement to proceed with a three-year programme for reforming three waters service delivery arrangements, to be delivered in parallel with an economic stimulus package of Crown investment in water infrastructure. This investment also needs to be aligned with any investments we are considering making in local government more generally, and the parallel processes underway through the Provincial Growth Fund and Crown Infrastructure Partners regarding ‘shovel-ready’ programmes.

13. For local government water infrastructure, I propose a dual approach, which is designed to:

13.1 stimulate investment, to assist economic recovery through job creation, and maintain investment in water infrastructure renewals and maintenance; and

13.2 fundamentally reform the water service delivery sector, to realise significant economic, public health, environmental, and other benefits over the medium to long term. (This would be an ‘opt in’ reform programme, in which councils that choose to participate would be eligible for stimulus funding, provided there are sufficient numbers of councils to provide entity scale.)

14. It is estimated that the economic stimulus would protect and create at least 11,000 jobs directly, and a total of 34,000 jobs once indirect effects are taken into account. It would generate $3.9 billion in additional GDP. Targeted investment would also ensure planned investments in water infrastructure continue and three waters reform objectives are met.

15. I am proposing that provision of the economic stimulus is conditional on local authorities opting in to service delivery reform, specifically the creation of large scale multi-regional water providers. The exact numbers and boundaries would be finalised following discussions with Ministers and local government, with decisions based on factors such as scale, communities of interest, and catchments.

16. This approach would realise a number of economic and other benefits associated with large scale water providers, address many of the systemic issues and infrastructure deficits facing the three waters system, and help us to deliver our reform objectives. Creating large providers with strong balance sheets should also support the supply of housing by enabling water infrastructure to be provided to new developments, which has been a big constraint for debt-limited councils in high-growth areas.

17. The proposed economic stimulus of up to \(9(2)(f)(iv)\) comprises three parts:

17.1 an early injection of \(9(2)(f)(iv)\) to support the local government sector to maintain planned investment and asset quality in the face of significant declines in council revenue – the release of which would be conditional on the sector supporting the service delivery reform programme (on an opt in basis);

17.2 a second, more scalable stimulus of up to \(9(2)(f)(iv)\) to support large scale asset replacements and the bringing forward of ‘no regrets’ investment in the latter half of the reform period;

17.3 programme reform and support costs of \(9(2)(f)(iv)\), including funding to enable the local government sector to participate in the reform process, and to conduct the highly complex legal, accountancy, taxation, and due diligence work associated with implementing the reforms (involving 67 councils).
18. The stimulus would be released in tranches, broadly aligned with COVID-19 recovery ‘waves’, to ensure there is sustained support from local government for the service delivery reforms. Approximately $\frac{9(2)(f)(iv)}{9(2)(f)(iv)}$ of the stimulus would be set aside for rural drinking water supplies, to help to address the specific challenges these suppliers are facing in delivering safe drinking water to consumers.

19. This paper sets out the objectives, benefits, and key features of the proposed multi-regional water providers – building on previous discussions with Three Waters Ministers, and my paper on service delivery reform in January 2020. It also confirms the Government’s bottom line that public ownership of water infrastructure must continue, and there must be protections against privatisation.

20. I am seeking agreement to specific components of the new water service delivery model, subject to discussions with local government and detailed policy work. I propose the new multi-regional water providers would be:

20.1 statutory, asset-owning entities, with commercial disciplines, and a competency-based board;

20.2 owned by local authorities, as shareholders, but with sufficient legal separation to ensure there are no restrictions on the entities’ ability to borrow.

21. A large number of other policy matters need to be explored further, including confirming the proposed multi-regional boundaries; the nature of local government shareholding arrangements; potential for Crown ownership; funding and financing arrangements; and the legislative framework that would be required to regulate the new entities (including economic regulation and mechanisms to protect consumer interests). We will need to consider and address Treaty-related rights and interests, and engage with iwi/Māori. We also need to consider options for addressing the funding challenges facing Crown water infrastructure providers within the context of these reforms.

22. I am proposing to report back with initial advice on all of these matters in $\frac{9(2)(f)(iv)}{9(2)(f)(iv)}$ followed by more detailed policy proposals in $\frac{9(2)(f)(iv)}{9(2)(f)(iv)}$. I anticipate the legislation needed to implement the reforms would be introduced in early 2021, and the new water entities would be ready to operate from 2022/2023.

23. It will take significant resources to administer and implement a reform programme of this magnitude and complexity, and to incentivise and enable the local government sector to support the reforms. I am seeking funding in 2020/21 to resource the first year of this large-scale transformation programme. This funding includes programme costs at a national and regional level, as well funding to ensure the transition for local authorities is well supported and other services are not compromised through the initial period of reform.

24. Subject to this funding being agreed, I am proposing the Department of Internal Affairs (DIA) leads the service delivery reform programme – working closely with local government representative bodies. It would be supported by the agencies that have been involved in the Three Waters Review to date, including The Treasury, Ministry of Business, Innovation and Employment, Ministry of Health, and Ministry for the Environment. Programme governance would continue to be provided by the large group of Three Waters Ministers.
25. I have already had initial conversations with representatives of the local government sector, including at the Central-Local Government Forum. It is clear that local government recognise the opportunities of reform, and the sector has expressed a willingness to work with us to design a reform programme. A joint working group will be formed between DIA, The Treasury, Local Government New Zealand, and the Society of Local Government Managers.

26. I am proposing that the joint working group would prepare an initial high-level agreement in June 2020, on how local government will work with government on the reform agenda. This group would then work to prepare a more detailed agreement (memorandum of understanding) that councils across New Zealand would have the opportunity to opt in to.

27. Initial funding from the economic stimulus package would be released to those councils that agree to the memorandum of understanding in August 2020. Councils that do not opt in at this point would still be able to do so at a later date, but would miss the first wave of stimulus investment.

28. The joint working group will also work on policy matters, with a view to providing detailed advice on these matters to Ministers by 1 December 2020.

29. Once agreement has been reached with councils, I anticipate that Crown Infrastructure Partners would have an oversight role in relation to allocation and use of the stimulus funding, in accordance with the agreements.

30. I am planning engagement with local government throughout this process. A sector engagement strategy is being developed to guide this work. I am also recommending we immediately resource councils and their representative bodies, so they are able to engage in the reform programme.

31. Finally, this paper also seeks agreement to investment of $51.410 million over four years to provide ongoing funding to Taumata Arowai, the new Water Services Regulator, and for the monitoring work associated with this Crown agent. Taumata Arowai will be responsible for regulating drinking water, and for a small number of complementary functions relating to wastewater and stormwater. This funding is needed to ensure work to establish and then operate Taumata Arowai can occur.

Background

32. Since late 2017, we have considered a series of papers relating to the system for regulating and managing the three waters, and the response to the Havelock North drinking water contamination event. These papers highlighted that, in many parts of the country, communities cannot be confident that drinking water is safe, or that good environmental outcomes are being achieved. They also raised concerns about the regulation, sustainability, capacity and capability of a system with a large number of localised providers, many of which are funded by relatively small populations.

33. We have already made considerable progress with regulatory reform. Legislation to create Taumata Arowai is currently being considered by the Health Committee, and work to build this new Crown agent is underway. Drafting of a separate Water Services Bill is nearly completed, and will give effect to our decisions to significantly strengthen the drinking water regulatory framework.
34. In January 2020, we considered the other main component of the Three Waters Review: reforms to service delivery and funding arrangements. We noted that the case for change continues to build, that there are particular objectives and bottom lines that need to be considered as part of any reforms, and that initial analysis indicates multi-regional or regional delivery models appear to perform best across these objectives and bottom lines. We agreed to continue to support local government to make voluntary changes to service delivery arrangements, and to set a one-year deadline for demonstrating progress has been made [CBC-20-MIN-0006 refers].

35. While the fundamental, underlying reasons for service delivery reform remain, a lot has changed since those decisions were made. We are now in the midst of a global pandemic, and experiencing a ‘once in a century’ economic shock. The challenges facing the local government sector, which provides the majority of three waters services, have been compounded by this event.

36. Responding to, and recovering from, COVID-19 means we must reconsider the position we took in January 2020, and explore other approaches to three waters reform. We also need to consider how to support the local government sector, enable economic recovery, and ensure much-needed investment in three waters infrastructure occurs – at a time when many ratepayers will be experiencing financial hardship.

37. Over recent weeks, Ministers have been asked to identify immediate opportunities for investment to cushion the blow of COVID-19, and help to kick-start the economy. Investment in water infrastructure is an area with significant potential to contribute to economic stimulus in the short term.

38. We are also being asked to consider the challenges facing our sectors, now and in coming years. We need to examine the opportunities that exist to address the long-term issues the country faces, and how we can recover from the impacts of COVID-19 to transition to a productive, sustainable economy. This could include reconsidering traditional institutional structures, and asset ownership arrangements, for example.

39. During April 2020, Three Waters Ministers met to discuss three waters investment and reform opportunities in light of the COVID-19 situation. These discussions built on the significant work and prior conversations over the past two and a half years. The approach I am proposing in this paper reflects the tenor of these discussions, and the consensus reached.

Analysis

Local government three waters providers are facing significant challenges, which are being exacerbated due to COVID-19

40. Throughout the Three Waters Review, we have heard about a number of systemic challenges facing the three waters sector, including:

40.1 significant investment requirements to address infrastructures deficits, and associated risks to public health and the environment;

40.2 capacity and capability issues relating to asset management and governance of water infrastructure, and service delivery;

2 The paper, Three waters service delivery and funding arrangements: approach to reform, was considered by the Cabinet Business Committee on 28 January 2020.
40.3 funding and affordability issues, particularly for smaller communities, driven by matters such as:

40.3.1 community expectations and regulatory requirements relating to water quality, treatment and management;
40.3.2 the need to replace ageing infrastructure, build resilience to climate change and natural hazards, and innovate;
40.3.3 increasing demand for water infrastructure in high-growth areas;
40.3.4 delivering regional economic growth, including by sustaining local employment across distributed water networks;

40.4 the lack of alignment between the development and operation of wastewater systems and a catchment-based regulatory system;

40.5 the impact on local government of transition to new three waters service providers, particularly the reduction in operational budgets that would occur if water assets were transferred.

41. The situation caused by COVID-19 means the local government sector is facing a series of additional issues and challenges, many of which relate to the three waters.

42. Prior to COVID-19, territorial authorities were planning on spending up to $8.3 billion in capital over the next five years on water infrastructure. However, COVID-19 is likely to cause significant decreases in revenue in territorial authorities over the short term. Revenues could decline by between 10 and 25 per cent over the next financial year, and local authorities are facing increased cost pressures. As a result, borrowing will be constrained due to lower debt limits that flow from lower revenues, and opportunities to raise revenue through rates, fees and charges will be extremely limited.

43. Investment in water infrastructure has traditionally been an area where councils have constrained spending in response to financial pressures. This is because investment in water infrastructure is long term, and has a less visible impact on communities than other forms of council expenditure. The Three Waters Review has highlighted that New Zealand’s water infrastructure already carries a burden of underinvestment. This is likely to worsen in response to COVID-19.

44. Officials have estimated that, in the absence of support from the Crown, territorial authorities will face pressure to reduce planned capital investment in three waters infrastructure by approximately $1.2 billion over the next three years.

45. Three waters providers will also be facing other pressures over the next few years, as our regulatory reforms begin to take effect, and communities increasingly experience the impact of climate change. For example, there will be more emphasis on compliance with drinking water regulatory requirements, and greater transparency about the environmental performance of wastewater and stormwater networks. The recent drought has demonstrated the significant issues, costs, and risks to public health associated with water shortages.
I am proposing a combination of Crown investment and fundamental service delivery reform to address these challenges, and support short- and long-term economic recovery

46. Many councils and communities will struggle to respond to these challenges. Without support, investment will not occur to the levels required, the condition of infrastructure will continue to decline, and there could be negative implications for public health and environmental outcomes. Sector capability and capacity issues will remain, and funding problems will progressively worsen.

47. The COVID-19 situation has also affected progress with voluntary service delivery reforms. Understandably, councils and communities have other priorities. It appears unlikely that we will be able to regain momentum to achieve voluntary reforms in the short/medium term, to the extent that is needed to deliver widespread improvements across the country.

48. We are presented with an opportunity to consider how to improve this situation, and to address a number of significant issues, both entrenched and new. We need to act now to respond to the immediate challenges, and to ensure current settings are not locked in for years to come, causing problems to re-emerge.

49. Following discussions with other Three Waters Ministers, I am seeking agreement to proceed with a three-year reform programme to address the issues facing the three waters sector and support economic recovery post COVID-19. My proposed approach has two, inter-related components, and is designed to:

49.1 stimulate investment, to assist economic recovery through job creation, and maintain investment in water infrastructure renewals and maintenance; and

49.2 fundamentally reform the water service delivery sector, to realise significant economic, environmental, health, and other benefits over the medium to long term. (This would be an ‘opt in’ reform programme, in which councils that choose to participate would be eligible for stimulus funding, provided there are sufficient numbers of councils to provide entity scale.)

50. This dual approach would be structured to achieve multiple objectives – both in relation to economic recovery, and delivering the multiple benefits that are associated with three waters reform.

51. To support COVID-19 recovery, we would be seeking to maximise the positive impact that any stimulus could provide to local economies and jobs, and address the impact of the change process during transition. The investment type and procurement support could be targeted at retaining local and lower skill jobs, preventing further deterioration in water infrastructure as council finances decrease, and avoiding investment in assets that may become stranded in future entities.

52. Through this proposal, we can also achieve the objectives for reforming the three waters system that were outlined in my January 2020 paper:

52.1 significantly improving the safety and quality of drinking water services, and the environmental performance of wastewater and stormwater systems (which are crucial to good public health and wellbeing, and achieving good environmental outcomes);

52.2 ensuring all New Zealanders have equitable access to affordable three waters services;
52.3 improving the coordination of resources and unlocking strategic opportunities to consider New Zealand’s infrastructure needs at a larger scale;
52.4 increasing the resilience of three waters service provision to both short- and long-term risks and events, particularly climate change and natural hazards;
52.5 moving the supply of three waters services to a more financially sustainable footing, and addressing the affordability and capability challenges faced by small suppliers and councils;
52.6 improving transparency about, and accountability for, the delivery and costs of three waters services, including the ability to benchmark the performance of service providers [CBC-20-MIN-0006 refers].

In the short term, targeted fiscal stimulus would help councils to fund asset renewals, create jobs, and generate additional GDP

53. I am proposing a targeted stimulus package of up to $9(2)(f)(iv)$ to invest in water infrastructure and support service delivery reform. This package comprises:

53.1 an early injection of $9(2)(f)(iv)$ to maintain planned investment and asset quality in the face of significant declines in council revenue;
53.2 a second, more scalable stimulus of up to $9(2)(f)(iv)$ to support large scale asset replacements, and the bringing forward of ‘no regrets’ investment in the latter half of the reform period.

54. The fiscal profile of the proposed investment is based on achievement of both stimulus and reform objectives. I propose that we progressively release funding to the local government sector, following demonstration of support for the reform programme and progress against well-defined milestones. The mechanisms for demonstrating support will be discussed with the sector shortly.

55. To provide fiscal certainty and confidence that we can achieve the reform objectives, I propose that a total funding envelope of $9(2)(f)(iv)$ is established to support this reform process. In this paper, I am seeking agreement to an allocation for tranche one of $9(2)(f)(iv)$ from the $9(2)(f)(iv)$ allocation, with delegation to the Minister of Finance, Minister of Local Government, Minister for Infrastructure, and Minister of Internal Affairs to release the funding to the sector, following demonstration of an agreed pathway to reform and subject to their satisfaction that the necessary conditions have been met.

56. Although this financial commitment from the Crown is substantial, this level of investment needs to be compared to the value of water assets that sit on council balance sheets. In total, councils have approximately $140 billion in total assets, of which $40 billion are three waters assets. Total depreciation expense on these three waters assets is $840 million per annum. $9(2)(f)(iv)$
57. Commitment to proceed with subsequent tranches would be signalled to the sector as part of my engagement in the next month. I note that the total quantum for subsequent tranches is scalable, and will need to be informed by our success with the sector in meeting milestones and the size of incentive required to secure reform.

58. Analysis indicates that this fiscal stimulus would protect and create at least 11,000 jobs directly, and a total of 34,000 jobs once indirect effects are accounted for. It would also generate an estimated $3.9 billion in additional GDP.

59. This investment would achieve:

59.1 programme-level support for major service delivery reforms across 67 territorial authorities (and water-related council-controlled organisations);

59.2 renewals to core water infrastructure, such as wastewater treatment plants and drinking water, wastewater and stormwater pipes (including depreciation), to prevent the further deterioration of assets – particularly in response to COVID-19 and declining council revenues;

59.3 the best ideas from ‘shovel worthy’ project initiatives, and new investments that emerge from combined multi-region asset management plans;

59.4 upgrades to non-compliant drinking water supplies, with an appropriate amount of funding tagged to upgrade marae-based water supplies (contributing to public health benefits associated with safe drinking water).

60. Specifically, I am proposing that approximately of the stimulus would be set aside for rural drinking water supplies, to help to address the challenges these suppliers are facing in delivering safe drinking water to consumers. There are a range of supply arrangements in rural and remote areas, including council and private providers, and further work is needed to establish how the funding would be targeted. I will explore how best to allocate the funding with the Minister for Infrastructure, and report back with further details in

61. I have considered alternatives to targeted investment of this kind, but there are significant challenges associated with other approaches.

62. One alternative would be to ask councils to fund further investments on their balance sheets, by utilising further borrowing. Additional borrowing of around $300 million per year was planned prior to COVID-19 to fund capital investment. However, the decrease in revenues will severely constrain councils’ ability to take on more debt, and some councils (particularly in high-growth areas) will quickly reach debt limits.

63. The reduction in revenue will mean most councils will need to curtail almost all of their borrowing programmes. It is estimated that, in aggregate, councils will only be able to borrow an additional $40 million per annum without breaching debt-to-revenue limits. This is insufficient to bridge the expected investment gap.
64. A variation of this option would be to support council debt through issuing some form of government bond. This would provide councils with the ability to borrow at rates closer to the Crown cost of borrowing, rather than prevailing rates available to them through the Local Government Funding Agency. This option is only attractive if the differential is large and councils have a greater ability to take on debt than current circumstances allow. Overall, the likelihood of this occurring is low, and unlikely to be sufficiently attractive to the sector nor sufficient to prevent deterioration of the infrastructure.

65. Another option would be to use alternative funding or financing arrangements to support further investment in three waters assets, such as Special Purpose Vehicles (SPVs). These vehicles could seek up-front capital from sources other than the Crown.

66. There are several challenges with this approach, particularly from an immediate response perspective, and they would not incentivise structural reform. The main issue is that SPVs and similar funding mechanisms are best suited to green-field developments or new asset construction. SPVs are not well-suited to brown-field development or renewal of assets, which is what the bulk of this programme of work is looking to support in the short to medium term.

67. In addition, SPVs typically rely heavily on private or overseas equity investment to fund up-front capital costs. Due to the economic shock relating to COVID-19, it is likely that ready access to private equity and capital will be limited, and the Crown will need to step in to help fill this gap in the short term. Even in instances where private equity is available, borrowing costs are likely to escalate substantially for firms to access this form of capital.

Provision of the stimulus would be conditional on local government opting in to service delivery reforms, to create multi-regional water service providers

68. In April 2020, Three Waters Ministers were asked to consider how water investment opportunities could support reform and be used to provide for economic stimulus in the context of COVID-19.

69. Ministers were presented with several options for providing investment, ranging from investment with no conditions, to investment that is conditional on aggregation of water services. There was a strong preference for providing a financial contribution that is conditional on aggregation, and for the creation of four or five multi-regional water service providers.

70. Our rationale for four or five entities relates to evidence about the size (population and customer density) over which scale efficiencies are likely to be achieved. This analysis has been supported by assistance from the Water Industry Commission for Scotland. Scotland is considered an exemplar in water reform internationally.

71. The preferred approach recognises that fundamental reforms to the water service delivery sector are needed to address the challenges and achieve the objectives described earlier, and to ensure investment in infrastructure continues. This is an opportunity to deliver broader economic, health, environmental, and other benefits over the medium to long term, across the country.
72. The alternative options, such as unconditional investment, or investment that is conditional on ‘best endeavours’ or on each individual council agreeing to a reform pathway, were not preferred. These options are unlikely to be effective, feasible, or have the desired level of impact. There is also a risk that unconditional investment would reduce sector interest in voluntary reform, may exacerbate regional inequities, and close the ‘window of opportunity’ for many years.

73. It is important to recognise the significant amount of Crown investment that is proposed. We need to ensure the reforms are commensurate with the investment, value for money can be demonstrated, and the impacts are felt across the country. Without consistent and widespread service delivery reform, it is likely that any infrastructure deficits will only be resolved temporarily, and entrenched structural and funding issues will remain in many places.

74. My proposal involves transformational structural reform and the creation of multi-regional, asset-owning water service providers. This would realise a number of economic and other benefits associated with large scale providers, address many of the systemic issues and infrastructure deficits facing the three waters system, and help us to deliver our reform objectives. Benefits include:

74.1 increased financial capacity and capability, with stronger, more flexible and resilient balance sheets, greater access to capital, and a more reliable investment pipeline;

74.2 opportunities to take a strategic and coordinated approach, to consider infrastructure needs at a larger scale and in the context of wider catchment outcomes;

74.3 building technical capabilities, with access to a larger, more specialist workforce, and the ability to innovate and make use of new technology;

74.4 enabling financial efficiencies and lower operating costs, by consolidating administration and overhead costs, and improving organisational capabilities;

74.5 enabling more consistent water charges, with the ability to harmonise tariffs across much larger areas.

75. Creating large scale providers with strong balance sheets should contribute positively to the supply of housing by enabling water infrastructure to be provided to new developments, which has been a big constraint for debt-limited councils in high-growth areas. The existing urban growth partnerships, and spatial planning, also provide an opportunity for integrating and coordinating large, multi-regional water providers with priority development areas and other key projects.

76. From a regulatory perspective, this approach would be beneficial in terms of operating and funding Taumata Arowai, the new Water Services Regulator. It would significantly reduce the number of regulated parties, while increasing the capacity and expertise within those entities. This would mean Taumata Arowai would work with four or five large scale, dedicated water entities, instead of 67 councils (some of which may need support to comply with the new drinking water regulatory system). It also makes it feasible to cover a sizeable portion of the organisation’s costs through levying the new, well-resourced water entities.
77. The benefits should not be overstated in the short term. While some benefits, such as stronger balance sheets, will be realisable immediately, others will take time. This is illustrated in Appendix B. We will need to support sustainable change, good long-term investment decision making, and a supported transition for councils and consumers.

78. I have considered alternative options to structural reform, but these options have disadvantages, do not deliver our reform objectives, or fail to address key challenges. For example, shared services models that do not involve asset ownership have a number of shortcomings, including the inability to access scale or scope efficiencies, and split accountabilities. The recent example of Wellington Water illustrates the need for new water entities to make their own funding and investment decisions, rather than relying on individual council owners for investment.

The new service delivery model would include the safeguards and design objectives we have considered previously

79. I am proposing the creation of a small number of multi-regional water service providers.

80. There will be further discussions with Ministers and local government about the exact number of new entities, and their boundaries. I am proposing that final decisions on these matters would be based on the following factors:

80.1 scale benefits – including at least one very large urban centre within each entity, to ensure the full benefits of scale are achieved through a larger network and population base;

80.2 communities of interest;

80.3 relationships with other jurisdictional boundaries, including catchments.

81. Earlier in the Three Waters Review, we agreed that, if a new model for water service delivery is created, this must include certain high-level design objectives:

81.1 financial sustainability, affordability, and resilience;

81.2 effective, efficient, and reliable services;

81.3 enable an effective, efficient regulatory system; and

81.4 minimise the negative impact of reform, where possible.

82. We have also expressed a clear and consistent message that public ownership of water infrastructure must continue, and there must be protections against privatisation. This has always been, and will continue to be, a bottom line. There has also been an ongoing interest in mechanisms that provide for local community input and local service delivery, opportunities for iwi/Māori participation, and expectations around how new multi-regional entities could better contribute to health and environmental outcomes.

83. If the approach in this paper is agreed, I am proposing that these design objectives and bottom lines would be an integral part of the policy development process, and would be reflected in legislation.
84. There are a number of options for protecting public ownership of water assets. This is already a feature of local government legislation, which prohibits the sale of water infrastructure and the divestment of ownership of water services. Similar protections would be carried into the legislation that creates new water entities. I would also expect officials to identify additional mechanisms for providing assurances about this important matter. This could be achieved through ownership arrangements, and/or forms of social outcome obligations (such as ‘kiwishare’, for example).

**I am also seeking agreement to core components of the service delivery model**

85. I am seeking in principle agreement to core components of the new water service delivery model, subject to detailed policy design work and discussions with local government. I am proposing that the new water entities would be:

85.1 statutory, asset-owning entities, with commercial disciplines, and a competency-based board;

85.2 owned by local authorities, as shareholders, but with sufficient legal separation to ensure there are no restrictions on the entities’ ability to borrow on similar lines to other utilities.

86. Establishing the new entities in statute is essential if we are going to create an effective, enduring ownership, governance, and service delivery model, and provide an appropriate regulatory framework (to protect the interests of consumers, for example). I do not consider existing institutional arrangements, such as council-controlled organisations, would be fit-for-purpose in these circumstances.

87. Providing for local authorities to be shareholders in the new entities is also important. This would be structured in a way that maintains and protects community ownership, but enables assets to be transferred to the new public entities. The basis for shareholding will need careful consideration and financial analysis. It could be possible to apportion shares on the basis of the condition of the assets that are transferred, to reward previous investment and good asset maintenance. There could also be potential to provide for some form of annual return to shareholders/councils.

88. If local authorities were to retain asset ownership, this would limit the new entities’ ability to borrow, as limits would be constrained by council debt limits or attitudes to debt. This could also result in sub-optimal investment decisions about assets that would benefit from a multi-regional (not district) solution.

89. Professional governance arrangements are essential to create some of the capability improvements that are required. This would separate the ownership and governance roles, and bring in specialist expertise.

**Further advice and decisions will follow in** 9(2)(f)(iv)

90. A number of highly-complex matters would need to be explored further during policy development and design work for the new service delivery model. These include:

90.1 the nature of local government shareholding arrangements;

90.2 the potential for the Crown to be a shareholder (for example, in recognition of stimulus funding), and for other investors to be party to financing (but not ownership/equity) arrangements;
90.3 funding and financing arrangements (including the fees and charges faced by consumers);

90.4 mechanisms that provide for local community input and local service delivery;

90.5 the nature and extent of the legislative framework that would be required to regulate the new entities, including economic regulation and mechanisms to protect consumer interests;

90.6 the scope of the new water entities’ remit, particularly regarding the provision of stormwater services, and drinking water and wastewater services that are currently the responsibility of private/community suppliers;

90.7 the potential use of instruments like government policy statements to guide/direct the new water entities.

91. I am proposing to report back with initial advice on these matters by 9(2)(f)(iv), alongside progress with reform discussions with local government, followed by more detailed proposals in 9(2)(f)(iv). This second report back will also inform our appetite to release the earmarked investment stimulus beyond tranche one to the sector.

92. One of the points we will need to consider is charging arrangements for water services. I am aware that councils currently use a variety of approaches, including fixed rates, volumetric charges, and general rates. It will be important to ensure consumers experience minimal disruption during the transition to, and implementation of, new multi-regional water entities. I anticipate consumers would continue to be charged on a similar basis to their existing arrangements, at least in the initial years of the entities’ operations. Volumetric charging is something that could be considered in future, but only when it makes sense to do so. I note that Scottish Water still raises its charges via local council rates notices.

93. We will also need to consider and address Treaty-related rights and interests, including in the design of the new water entities. A preliminary analysis has been undertaken, and is attached at Appendix C. I will report back with further advice in 9(2)(f)(iv).

94. This preliminary analysis has been informed by previous engagement with iwi/Māori, in relation to proposals for the new drinking water regulatory framework and creation of Taumata Arowai. During these engagement sessions, a number of comments were made that are relevant to reforms to service delivery arrangements.

95. The potential for reform of water service providers is likely to present a different range of Treaty interests, though, which will need to be identified and explored further. An engagement strategy will be prepared to inform this work. Engagement and analysis will be informed by guidance material that has been prepared through the Te Arawhiti portfolio, and intersections with our response to WAI 262 and WAI 2358. When engaging with iwi/Māori, we will seek to use existing platforms and relationships, such as the National Iwi Chairs Forum, to minimise the consultation fatigue iwi may be experiencing.
96. Finally, I am aware that several government agencies are facing significant costs to upgrade their water infrastructure. DOC has a significant number of sites around the country, many of which will require water infrastructure upgrades. These sites are generally small and spread out.

97. The stimulus package in this paper is targeted at local government water infrastructure. I do not want to diminish the amount of investment that would be directed at improving local infrastructure and incentivising sector support for service delivery reform. This could happen if Crown-owned water infrastructure was included in this stimulus package.

98. However, I recognise the challenges that DOC and other Crown water service providers, such as the Department of Corrections and New Zealand Defence Force, are facing and the implications this may have. Officials from the relevant agencies will do further work to explore the options for addressing these challenges. This could include the potential for the water investment stimulus package to be broadened, and options for Crown water supplies to be included within the scope of the new multi-regional entities. I am advised that some agencies have expressed an interest in transferring responsibility for some of their water assets to the new water entities, if this was a possibility. I will report back with further advice in this stimulus package.

I am proposing a three-year reform programme and three tranches of investment – but the substantive work would begin immediately

100. Maintaining momentum is critical. If my proposed approach is agreed, we will need to move quickly to develop and agree detailed policy proposals, engage with key stakeholders, and begin releasing the stimulus package.

101. With this in mind, I intend to seek policy decisions in this stimulus package, with a view to legislation being introduced in early 2021.

102. Overall, I consider that a three-year programme is needed to design and implement the reforms effectively. This approach reflects that it will take time to:

102.1 engage meaningfully with local authorities, and for them to understand and come on board with the reforms, and adapt their organisations;

102.2 engage meaningfully with iwi/Māori, and consider Treaty of Waitangi rights and interests;

102.3 communicate and socialise the reforms with the public;

102.4 develop and enact the legislation needed to establish new water entities, and the associated regulatory framework;
102.5 work through the complex transactional issues related to the aggregation of water services and assets from 67 individual entities into a small number of multi-regional entities, particularly as information about assets and revenue is poor.

103. I am proposing that investment is released in three tranches, broadly aligned with the investment ‘waves’ of COVID-19 recovery. This investment is a vital tool to incentivise buy-in from the local government sector, and ensure support is maintained. A single tranche of funding, of a size that is able to be immediately deployed, is unlikely to achieve the desired structural reforms.

104. The diagram at Appendix A provides a high-level indicative timeframe for the proposed three-year programme.

105. My officials have also been developing the work programme needed to develop and implement the service delivery reforms. An initial programme structure includes the following workstreams:

105.1 Stakeholder engagement and communications;
105.2 Policy, legislation, and sector guidance;
105.3 Structuring the new entities;
105.4 Establishment and implementation;
105.5 Project management, reporting, and programme development.

106. The workstreams and structure are being designed to ensure that the programme can move at pace, is responsive (particularly to any further potential changes in the environment as a result of ongoing COVID-19 impact), connected to the stimulus and regulatory reform activities, and suitably resourced. Commencing the front-end work as soon as possible, to enable negotiations with local authorities and development of policy positions, will be key to enabling programme acceleration.

107. It will take significant resources to administer and implement a reform programme of this magnitude and complexity. The financial implications section of this paper sets out the funding being sought to resource the programme.

108. Subject to this funding being agreed, I am proposing the Department of Internal Affairs (DIA) leads the service delivery reform programme. The Department is the agency responsible for, and has primary relationship with, local government, and has been leading the Three Waters Review for the past three years. Officials would work closely with other key agencies, including The Treasury, Ministry of Business, Innovation and Employment, Ministry of Health, and Ministry for the Environment, as they have been throughout the Review.

109. I am proposing that programme governance would continue to be provided by the group of Three Waters Ministers. These Ministers will meet regularly to guide the direction of this work, discuss policy options, and ensure momentum is being maintained and all aspects of the programme are on track.

110. The reform programme will have a close relationship with the oversight and release of the wider economic stimulus package. The detail of this work will need to be included in advice from The Treasury, Crown Infrastructure Partners, and the Department of Internal Affairs, in the context of other stimulus approaches.
111. My officials would be involved in designing the stimulus package and deciding how it would be spent, given this relates to the local government sector and our water service reform objectives. Once agreement has been reached with local government about the specific reform and funding package that councils would be opting in to, I anticipate Crown Infrastructure Partners would have oversight of the allocation and use of the three waters stimulus funding – in accordance with the agreements.

**It is important to get support from local government, but there would be a deadline and agreed mechanisms for demonstrating that support**

112. Support from local government is vital if we are to deliver the proposals in this paper, and achieve our short- and long-term goals. However, there is a need to move quickly to develop agreements with the sector, shape the broad reform agenda, and undertake detailed policy design work. It will not be helpful to our reform objectives, or community interests, to enter into protracted negotiations before the policy reform work can begin.

113. I have already had initial conversations with the Local Government New Zealand (LGNZ) National Council, and the Central-Local Government Forum. It is clear that local government recognises the opportunities of service delivery reform, and benefits of infrastructure investment. The sector has expressed a willingness to work with us to design a reform programme, on a high-trust and ‘opt in’ basis. To achieve this, a joint working group will be formed between DIA, The Treasury, LGNZ and SOLGM.

114. I am proposing that the joint working group will prepare an initial high-level agreement in June 2020, on how local government will work with government on the reform agenda. This group would then work to prepare a more detailed agreement (a memorandum of understanding) that councils across New Zealand would have the opportunity to opt in to.

115. Initial funding from the economic stimulus package would be released to those councils that agree to the memorandum of understanding in August 2020. Councils that do not opt in at this point would still be able to do so at a later date, but would miss the first wave of stimulus investment.

116. In parallel, the joint working group will also explore the detailed policy reform matters referred to earlier in this paper, with a view to providing advice on these matters to Ministers by 1 December 2020.

117. I am planning further engagement with local government, both in this early, strategic phase, and on an ongoing basis as the reforms are developed and implemented. My approach to engagement will involve a combination of discussions with sector representative bodies and direct engagement with councils.

118. Officials will also engage with representative bodies and councils – building on existing relationships between the Department of Internal Affairs and the sector, through the Central/Local Government Partnerships team and Three Waters Review. A sector engagement strategy is being developed to guide this work. To support this process, I recommend that we immediately resource councils and their representative bodies, so they are able to engage in the reform programme.
119. As noted, I am recommending we use tranches of investment, released at key milestones, to achieve our multiple goals of ensuring sector support for the reform agenda is sustained, the stimulus has the desired impact, and our reform objectives are progressed.

120. It will be important that each council has a good indication of what the stimulus will mean for its community, and how much funding they are likely to receive if they opt in to the reform programme.

121. A detailed approach to allocation would be worked through with the local government sector. However, I anticipate the allocation could be based on a combination of geographical size, population, and asset information, and would be consistent with the proposed Framework for aligning stimulus spending with the transition to a clean, green and carbon neutral New Zealand, once adopted by Cabinet.

122. I also expect conditions will be attached to the funding. These conditions are still being developed, but are likely to include factors such as:

   122.1 the funding must be spent on three waters investment – though councils would be best placed to decide how to prioritise this investment in their districts;
   122.2 avoiding ‘white elephant’ infrastructure projects;
   122.3 investing in a way that is cognisant of climate change impacts; and
   122.4 prioritising job intensive activities (including creating local jobs).

123. I will report back on progress with sector engagement, the memorandum of understanding, and funding allocation criteria and conditions, in 9(2)(f)(iv).

Funding for Taumata Arowai

124. In September 2019, Cabinet agreed to establish a new Waters Services Regulator, ‘Taumata Arowai’, as a Crown agent. Taumata Arowai will become responsible for regulating our drinking water system, and for a small number of complementary functions relating to wastewater and stormwater.

125. Legislation to establish Taumata Arowai is due to be reported back by the Health Committee by 17 June 2020. Work to establish Taumata Arowai within the Department of Internal Affairs is also progressing well. This work is now paused, though, pending a decision on future funding. The establishment team currently has only $3 million in 2020/21.

126. Further funding is required to progress establishment, and then operate Taumata Arowai, including moving to a permanent staffing structure. I note that it is expected that Taumata Arowai will include a significant regional footprint, through its frontline staff.

127. I am seeking agreement to investment of $51.410 million over four years to provide ongoing funding for Taumata Arowai, and the work associated with monitoring this Crown agent.

128. 9(2)(f)(iv)
Implementation of the service delivery reform programme

129. I propose that the workstreams outlined earlier in this paper will be delivered over a three-year period, split into the following three consecutive phases:

129.1 Phase 1 (June – December 2020) – Programme initiation, preparation of memoranda of understanding, policy development, and initial entity structuring work.

129.2 Phase 2 (2021) – Legislative process; detailed due diligence work and entity structuring work.

129.3 Phase 3 (2022) – Entity establishment and implementation.

130. Key milestones are as follows:

130.1 August 2020: Local government agreement to memorandum of understanding, linked to release of initial stimulus funding.

130.2 Early-mid 2021: Legislative drafting process, and Bill introduced.

130.3 Early 2022: Legislation enacted.

130.4 Early 2023: New entities legally established and transfer of assets and liabilities complete.

130.5 1 July 2023: Full operations of new entities from the beginning of the financial year.

131. As proposed above, a programme team led by the Department of Internal Affairs will provide the resource for the project management, local government engagement (leveraging the Central/Local Government Partnership team), policy design, legislative phase, iwi/Māori engagement, and stakeholder engagement. This team will work with representatives from LGNZ and SOLGM, through a joint working group.

132. The complexity of the programme, and speed at which it must progress, will result in the need to source external advice to support policy development. This advice is likely to consist of legal, commercial, financial, taxation, and governance advice, as required. This will be most intensive during the first 12 to 18 months of the programme, as structural considerations and policy and legislative developments peak.

133. To ensure continued local authority engagement in the process, I anticipate that some of the work required to inform the structuring and financial considerations will be undertaken by local authorities directly. Officials will provide local authorities with clear guidance on these activities to ensure efficiency and consistency. A portion of the outlined funding allocation will be to fund these activities.

134. Programme monitoring and governance arrangements are being developed. These will include mechanisms for monitoring local spending decisions, to ensure these align with the parameters and intentions of the economic stimulus package, and for tracking progress with projects. Three Waters Ministers will receive regular updates, to provide assurances about how the Crown’s investment is being spent.
Financial implications

9(2)(f)(iv)
143. This paper also seeks funding to support the establishment and operation of Taumata Arowai, the new Water Services Regulator, an associated monitoring costs, as per the table below:

**Table 2: Taumata Arowai and associated monitoring costs**

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<thead>
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<th>$million</th>
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<tbody>
<tr>
<td></td>
<td>2020/21</td>
</tr>
<tr>
<td>Taumata Arowai</td>
<td>13.940</td>
</tr>
<tr>
<td>Department of Internal Affairs monitoring costs</td>
<td>-</td>
</tr>
<tr>
<td>Total operating</td>
<td>13.940</td>
</tr>
<tr>
<td>Total capital</td>
<td>1.400</td>
</tr>
</tbody>
</table>
Legislative implications

145. This paper does not have any immediate legislative implications. However, if the proposed approach is agreed to, it will result in the development of policy proposals that require legislation to implement. I anticipate that policy decisions resulting in drafting instructions would be made in December 2020, and Parliamentary Counsel Office would be asked to begin drafting the Bill in early 2021.

Impact analysis

Regulatory Impact Statement

146. The Treasury has asked that the following statement is included in this paper:

147. “No Regulatory Impact Analysis has been provided with this proposal. The Department of Internal Affairs has requested the Regulatory Impact Assessment (RIA) requirement is suspended, but the Treasury does not consider this proposal to be a direct response to COVID-19. The RIA needs to be prepared. While under normal situations we would recommend a supplementary analysis for the overall program, in this case the RIA can be provided at a later stage when individual proposals from the Three Waters package are submitted to the Cabinet. Delaying the RIA is consistent with the integration of this proposal to the Wave 2 and 3 recovery program that responds to COVID-19.

148. The Department has provided a reduced form of RIA (Appendix D), which covers problem definition and objectives, identifies a range of options to address the key issues, and explains clearly how the preferred option has emerged. At the same time, the timeline of investments remains unclear and the proposal does not discuss potential alternatives, such as increasing the borrowing thresholds of local authorities that can be more flexible during the economic recovery. There is also a lot of uncertainty about the decreased revenue due to COVID-19, which is a crucial parameter for determining immediate funding needs.”

Climate Implications of Policy Assessment

149. None.

Population implications

150. None.

Human Rights

151. None.
Consultation
152. Ministry for the Environment, Ministry of Health, Ministry of Business, Innovation and Employment; The Treasury; New Zealand Transport Agency; Ministry for Primary Industries; Ministry of Civil Defence and Emergency Management; Ministry of Housing and Urban Development; Department of the Prime Minister and Cabinet; Te Puni Kōkiri; and Te Arawhiti have been consulted on this Cabinet paper.

153. The Department of Conservation, Ministry of Education, New Zealand Defence Force, and Department of Corrections have operational responsibility for three waters services and have been consulted on this Cabinet paper in this capacity.

Communications
154. A plan for communicating the decisions in this paper is being prepared, and will be discussed with the Prime Minister and appropriate Ministers.

Proactive Release
155. I intend to proactively release this paper, subject to any redactions, upon the conclusion of discussions with local government and when a decision is reached on reform.

Recommendations
156. The Minister of Local Government recommends that Cabinet Economic Development Committee:

1. note that, in January 2020, we considered reforms to local government water service delivery and funding arrangements, agreed to support local authorities to make voluntary changes, and set a one-year deadline for demonstrating progress [CBC-20-MIN-0006 refers];

2. note that since those decisions were made, COVID-19 has exacerbated the three waters challenges facing the local government sector and, without support, investment will not occur to the levels required, the condition of infrastructure will continue to decline, sector capability, capacity and funding issues will remain, and there could be negative implications for public health and environmental outcomes;

3. note that to respond to, and recover from, COVID-19 we need to identify opportunities for investment, such as water infrastructure, to cushion the blow and help to kick-start the economy, and need to reconsider the approach to restructuring water services;

4. note that in April 2020, the Ministers of/for Local Government, Health, Environment, Infrastructure, Rural Communities, Conservation, Climate Change, Commerce and Consumer Affairs, and Urban Development (“Three Waters Ministers”) discussed opportunities to support economic recovery post COVID-19, and identified a dual approach of:

4.1 stimulating investment, to assist economic recovery through job creation, and maintain investment in water infrastructure renewals and maintenance; and
4.2 fundamentally reforming the water service delivery sector, to realise significant economic, environmental, public health, and other benefits over the medium to long term;

5. **agree** to proceed with a three-year programme for reforming three waters service delivery arrangements, to be delivered in parallel with an economic stimulus package of Crown investment in local authority water infrastructure, which together could:

5.1 protect or create at least 11,000 jobs, and generate an estimated $3.9 billion in additional GDP;

5.2 ensure planned investments in water infrastructure continue;

5.3 incentivise the local government sector to support the reform agenda;

6. **agree** that provision of the economic stimulus is conditional on local authorities opting in to service delivery reform and, specifically, the creation of a small number of multi-regional water service providers;

7. **agree** there will be further discussions with Three Waters Ministers and local government about the exact number and boundaries of the multi-regional water service providers, and final decisions would be based on the following factors:

7.1 achieving scale benefits – including at least one very large urban centre within each entity, to ensure the full benefits of scale are achieved through a larger network and population base;

7.2 communities of interest;

7.3 relationships with other jurisdictional boundaries, including catchments;

8. **agree** that the following high-level design objectives would be reflected in the new multi-regional models for water service delivery:

8.1 financial sustainability, affordability, and resilience;

8.2 effective, efficient, and reliable services;

8.3 enable an effective, efficient regulatory system;

8.4 minimise the negative impact of reform, where possible;

9. **agree** that the new multi-regional models for water service delivery would include the following safeguards:

9.1 mechanisms that provide for continued public ownership of water infrastructure, and protect against privatisation;

9.2 mechanisms that provide for community input and local service delivery;

10. **agree** in principle that, subject to discussions with local government and detailed policy design work, the new multi-regional water providers would be:

10.1 statutory, asset-owning entities, with commercial disciplines, and a competency-based board;

10.2 owned by local authorities, as shareholders, but with sufficient legal separation to ensure there are no restrictions on the entities’ ability to borrow on similar lines to other utilities;

11. **note** that a number of related matters would need to be explored through further policy development and design work, including:

11.1 the nature of local government shareholding arrangements;
11.2 the potential for the Crown to be a shareholder, and for other investors in the new entities;
11.3 funding and financing arrangements;
11.4 mechanisms that provide for local community input and local service delivery;
11.5 the nature and extent of the legislative framework that would be required to regulate the new entities, including economic regulation and mechanisms to protect consumer interests;
11.6 the scope of the new water entities’ remit, particularly regarding the provision of stormwater services, and drinking water and wastewater services that are currently the responsibility of private/community suppliers;
11.7 the potential use of instruments like a government policy statement to guide/direct the new water entities;
11.8 the options for addressing the funding challenges facing Crown water infrastructure providers within the context of these reforms;

12. note that there will also need to be further work to consider and address Treaty-related rights and interests, including in the design of the new water entities, and a strategy for engaging with iwi/Māori is being prepared to inform this work;

13. invite the Minister of Local Government to report back in:
13.1 9(2)(f)(iv), with further advice on the matters in recommendations 7 to 12 above, and on the allocation of funding to rural drinking water suppliers as referred to in recommendation 25 below; and
13.2 9(2)(f)(iv), with detailed policy proposals relating to the matters in recommendations 7 to 12, to inform the preparation of legislation to give effect to the reforms during 2021;

14. note that an initial work programme has been identified to implement the proposed reforms to water service delivery arrangements, including the following workstreams:
14.1 stakeholder engagement and communications;
14.2 policy, legislation, and guidance;
14.3 structuring the new multi-regional water entities;
14.4 establishment and implementation;
14.5 project management, reporting, and programme development;

15. note that, subject to agreement to funding in the financial recommendations below, the Department of Internal Affairs will lead the service delivery reform work programme, working closely with other agencies including The Treasury, Ministry of Business, Innovation and Employment, Ministry of Health, and Ministry for the Environment, and with sector representative bodies;

16. agree that governance for the service delivery reform programme will be provided by the group of Three Waters Ministers, as referred to in recommendation 4;
Engagement with the local government sector

17. **note** that, while gaining support from local government is vital, it is important to move quickly to develop agreements with the sector, shape the broad reform agenda, and to undertake detailed policy design work, and it will not be helpful to enter into protracted negotiations with the sector before this work can begin;

18. **note** that officials from the Department of Internal Affairs (DIA), The Treasury, Local Government New Zealand (LGNZ), and the Society of Local Government Managers (SOLGM) will form a joint working group, which will prepare:
   18.1 an initial high-level agreement on how local government will work with government on the service delivery reform and investment stimulus agenda, in June 2020;
   18.2 a more detailed agreement (memorandum of understanding) that councils across New Zealand would have the opportunity to opt in to in August 2020; and
   18.3 advice on the policy matters referred to in recommendations 7 to 11 above, including the suggested number and structure of the new multi-regional water entities, by 1 December 2020;

19. **agree** that:
   19.1 initial funding from the economic stimulus package would be released to those councils that agree to the memorandum of understanding referred to in recommendation 18.2, in August 2020, provided that a sufficient number of councils opt in to make relevant new service delivery entity viable; and
   19.2 councils that do not opt in at this point would still be able to do so at a later date, but would not receive the first amount of stimulus investment;

20. **note** that once agreement has been reached with councils, it is anticipated that Crown Infrastructure Partners would have an oversight role in relation to the allocation and use of the economic stimulus, in accordance with the agreements;

21. **note** that there will be continued engagement with local government, including direct engagement with councils, and an engagement strategy will be developed to guide this work;

22. **invite** the Minister of Local Government to report back on progress with sector engagement in 9(2)(f)(iv);

Financial implications

23. **note** that it will take significant resources to administer and implement the complex service delivery reform and investment programme described above, incentivise and enable the local government sector to support the reforms, address infrastructure deficits, and provide an appropriate economic stimulus;
26. agree to invest $51.410 million over four years to provide ongoing funding to the new Water Services Regulator, Taumata Arowai, the new Crown agent responsible for overseeing the drinking water regulatory systems and the delivery of a small number of centralised wastewater and stormwater functions; and cover the costs associated with monitoring this entity;

27. agree to increase funding in Vote Internal Affairs to meet the costs associated with the three waters reform programme, and the ongoing operations of Taumata Arowai;

28. note that the funding to deliver the three waters reform programme will support local government recovery from COVID-19 and contribute to the revitalisation of the economy;
32. agree to add the following new category to the multi-category appropriate “Local Government Administration” to support the new Crown agent, Taumata Arowai:

<table>
<thead>
<tr>
<th>Title</th>
<th>Type</th>
<th>Scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taumata Arowai</td>
<td>Non-departmental Output Expense</td>
<td>This category is limited to supporting Taumata Arowai in meeting its statutory responsibilities to regulate New Zealand’s water supplies.</td>
</tr>
</tbody>
</table>
Publicity

42. note that the Minister of Local Government intends to proactively release this paper, subject to any redactions, upon the conclusion of discussions with local government and when a decision is reached on reform.
Authorised for lodgement

Hon Nanaia Mahuta

Minister of Local Government

Appendix A redacted under section 9(2)(f)(iv)
APPENDIX B – Indicative benefits of large scale, multi-regional water providers over time

<table>
<thead>
<tr>
<th>Benefit</th>
<th>Current state description</th>
<th>Strategic shift</th>
<th>Short term 3-5 years</th>
<th>Medium term 5-10 years</th>
<th>Long term 10-20 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improved financing arrangements</td>
<td>Most councils finance water-related investments from a mix of rates and borrowing.</td>
<td>Aggregated entities would have greater capacity to borrow against assets.</td>
<td>Realised (i)</td>
<td>Sustained</td>
<td>Sustained</td>
</tr>
<tr>
<td>Improved performance information</td>
<td>Current performance information is limited, leading to poor quality investment decisions by both current suppliers and consumers.</td>
<td>Introduction of performance measures related to asset performance, consumer choices and efficiency (including losses). Technology may have a role in supporting improved performance.</td>
<td>Realised (ii)</td>
<td>Sustained</td>
<td>Sustained</td>
</tr>
<tr>
<td>Improved funding and pricing arrangements</td>
<td>Mixed understanding among consumers about the cost of water service provision, and a lack of transparency. A range of funding instruments are used with inconsistent application of good funding principles (e.g. efficiency, equity and fairness). There are incentives biases toward short term decision making.</td>
<td>A greater range of funding instruments would be introduced through time, including the potential to consider use of volumetric charges (e.g. for industrial users). It is important to differentiate charges for water versus charges to recover costs for water services.</td>
<td>Unrealised</td>
<td>Realised (iii)</td>
<td>Sustained</td>
</tr>
<tr>
<td>Improved expertise and capability</td>
<td>Levels of capability generally correlate with scale. Many councils have relatively limited capacity, expertise, technology and systems.</td>
<td>Increased levels of specialisation and expertise as a result of aggregation. Improved opportunities to innovate and use new technology.</td>
<td>Realised</td>
<td>Sustained</td>
<td>Sustained</td>
</tr>
<tr>
<td>Improved other operating efficiencies</td>
<td>Poor information about levels of general operating efficiency, although we are aware that there are some examples of cross subsidy between water services and other services.</td>
<td>Greater focus on scale efficiencies will result.</td>
<td>Unrealised</td>
<td>Unrealised</td>
<td>Realised (iv)</td>
</tr>
<tr>
<td>Improved asset management</td>
<td>Poor information about the overall state of assets across the country, including the likely investment requirements.</td>
<td>Increased scale is expected to result in improved asset management through longer term and larger scale investment choices – including across catchments. Particularly the case for water treatment investment and use of alternative technologies.</td>
<td>Unrealised</td>
<td>Unrealised</td>
<td>Sustained</td>
</tr>
<tr>
<td>Improved procurement practice</td>
<td>Absence of scale efficiencies means procurement benefit is not realised. Many councils have realised economies of scale with contracted services for treatment and distribution, but providers have significant leverage.</td>
<td>Scale efficiencies in contracting practices.</td>
<td>Realised (v)</td>
<td>Sustained</td>
<td>Sustained</td>
</tr>
<tr>
<td>Improved safety, quality and environmental outcomes</td>
<td>Government has taken steps to improve regulatory practice related to water quality. A further distancing of provision from regulatory function may also improve practice with respect to environmental outcomes (including consenting).</td>
<td>Structural aggregation will support a functional separation of regulatory and ownership interests in addition to increased scale and specialisation in good regulatory compliance within individual entities.</td>
<td>Unrealised</td>
<td>Realised (vi)</td>
<td>Sustained</td>
</tr>
</tbody>
</table>

(i) Potential for extra borrowing capacity between $50M - $100M per year, starting in year 3 if entity increases gearing ratio to 20% against net asset value.
(ii) Improved asset performance could lead to better capital allocation, reducing capital plan costs by $500M - $1.08 billion across LTP forecast period for investment in infrastructure, with a per year reduction of approximately $100M starting in year 3.
(iii) Potential for additional borrowing capacity and increases in revenue that is allocated to new entities, but difficult to quantify at this point.
(iv) Other operating efficiency improvements are difficult to estimate and may be modest in the short term particularly if a transition is supported for territorial authorities.
(v) Improved procurement practice could lead to better capital allocation, reducing capital plan costs by $500M - $1.08 billion across the LTP forecast period for investment in 3 Waters, with a per year reduction of approximately $100M starting in year 3.
(vi) The range of benefits is difficult to estimate at this stage.
APPENDIX C – Preliminary analysis of Treaty of Waitangi considerations

<table>
<thead>
<tr>
<th>Rights</th>
<th>Considerations</th>
<th>Preliminary interest analysis (informed by prior engagement about three waters reforms and creation of Taumata Arowai)</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Article two – Rangatiratanga</strong></td>
<td>Are there options for Māori to exercise rangatiratanga while recognising the right of the Crown (including through local government) to govern?</td>
<td>Introduction of new governance arrangements will give rise to interests in co-governance opportunities.</td>
<td>Further work is required on the impact of the potential of asset transfer and Treaty issues. Co-governance can occur in several areas outside of those related to continued public ownership to better reflect local and iwi interests. Opportunities will exist to materially improve the connection between iwi/Māori rights and interests in the application of mātauranga and in better application of regulatory instruments related to water quality and RMA obligations to support kaitiakitanga. This will align with the statutory objective of Taumata Arowai to give effect to Te Mana o te Wai.</td>
</tr>
<tr>
<td></td>
<td>What role is there for Māori in design and implementation?</td>
<td>Iwi have expressed an appetite to have a role in water service delivery</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Does the reform offer an opportunity to enhance Māori wellbeing or build Māori capability and capacity?</td>
<td>Iwi/Māori have expressed dissatisfaction with the Treaty partnership approach and cultural responsiveness of current territorial authority service delivery. This includes understanding and application of mātauranga Māori frameworks.</td>
<td></td>
</tr>
<tr>
<td><strong>Article three – Rights as Citizens</strong></td>
<td>What are the implications for equitable outcomes?</td>
<td>Iwi/Māori raised the importance of ensuring that water services are affordable for all and equitably provide for safe drinking water that contributes to improved health outcomes.</td>
<td>Consumer protections will need to ensure issues of equity, particularly as it applies to rural and remote communities, are adequately addressed. Fiscal stimulus should be designed to encourage maximum local job creation and support mechanisms such as social procurement and skills matching services. Issues related to how multi-regional entities are able access funding including equity partners/investment sources.</td>
</tr>
<tr>
<td></td>
<td>What considerations should support legal values including natural justice, due process, fairness and equity including through regulatory processes?</td>
<td>Iwi/Māori have raised the potential for Māori to more directly benefit from alternative delivery mechanisms (e.g. jobs, social enterprise).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>What does a tikanga lens bring to consideration of the issues?</td>
<td>Iwi organisations have also expressed a desire to invest in the water infrastructure sector.</td>
<td></td>
</tr>
</tbody>
</table>
“Investing in water infrastructure to accelerate reform and support economic recovery post COVID-19”

Supplementary information – context and options analysis

Overview of proposed approach

1. The proposal involves the development and implementation of a three-year programme for reforming three waters service delivery arrangements, which would be delivered in parallel with a 9(2)(f)(iv) economic stimulus package of Crown investment in water infrastructure.

2. The proposed approach is designed to achieve dual goals: supporting economic recovery post COVID-19, and addressing persistent systemic issues facing three waters infrastructure and services. This would be done through a combination of:
   2.1 stimulating investment, to assist economic recovery through job creation, and maintain investment in water infrastructure renewals and maintenance; and
   2.2 fundamentally reforming the water service delivery sector, into a small number of multi-regional providers, to realise significant economic, environmental, and other benefits over the medium to long term.

3. Regarding the service delivery reforms, the proposed approach involves:
   3.1 the creation of a small number of multi-regional, asset-owning water providers, which would be statutory entities;
   3.2 protecting public ownership within the new service delivery models, and developing ownership arrangements that involve local government.

4. This supplementary information paper provides the context for these proposals, and explains the alternative options that have been considered. It is informed by the work and stakeholder engagement undertaken to date in the Three Waters Review, and previous decisions taken by Cabinet.

5. If the overall approach is agreed to, a large number of related matters would need to be explored further during policy development and design work. These matters would be the subject of further advice and report backs, following detailed options identification and analysis, and stakeholder engagement. They are not considered in this document.
Context

6. Over the past two and a half years, the Minister of Local Government has been leading a cross-government review of the system for regulating and managing drinking water, wastewater and stormwater (the Three Waters Review). A group of Three Waters Ministers\(^1\) has met regularly to discuss and provide input into this work. A large group of agencies, led and coordinated by the Department of Internal Affairs, have provided advice to these Ministers.

7. Cabinet has considered, and made a series of decisions on, a series of papers relating to the Three Waters Review:

7.1 *Review of three waters infrastructure: key findings and next steps* (April 2018).

7.2 *Future state of the three waters system: regulation and service delivery* (November 2018).

7.3 *A Plan for Three Waters Reform* (July 2019).

7.4 *Strengthening the regulation of drinking water, wastewater and stormwater* (July 2019) – supported by a Regulatory Impact Assessment.

7.5 *Institutional arrangements for a drinking water regulator* (September 2019) – supported by a Regulatory Impact Assessment and business case.

7.6 *Three waters service delivery and funding arrangements: approach to reform* (January 2020).

8. The current paper, *Investing in water infrastructure to accelerate reform and support economic recovery post COVID-19* (May 2020), builds on and is informed by previous decisions made by Cabinet, as well as discussions with Three Waters Ministers about service delivery reform and infrastructure investment, and stakeholder engagement. The key decisions that are relevant to the current paper are outlined in this document. There has been no indication that these decisions need to be reconsidered.

Problem definition

9. The problem definition is well established in previous Cabinet papers, regulatory impact analyses, and briefing material. Several of the Cabinet papers explored the problems and challenges facing the three waters system in considerable detail. The Regulatory Impact Assessment, *Strengthening the regulation of drinking water, wastewater and stormwater* (July 2019), also included an overview of the key problems.

10. Some of these problems are already being addressed through significant legislative changes to the drinking water regulatory framework, and the creation of a new Water Services Regulator – Taumata Arowai. The proposed programme of reforms to the service delivery system is intended to address many of the other problems, as well as supporting the long-term effectiveness and efficiency of Taumata Arowai and the new drinking water regulatory framework.

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\(^1\) Three Waters Ministers include the Ministers of/for: Local Government; Health; Environment; Infrastructure; Rural Communities; Conservation; Climate Change; Commerce and Consumer Affairs; and Urban Development.
11. In summary, previous papers highlighted that, in many parts of the country, communities cannot be confident that their drinking water is safe, or that good environmental outcomes are being achieved from wastewater and stormwater systems. They also raised concerns about the regulation, sustainability, capacity and capability of a system with a large number of localised providers, many of which are funded by relatively small populations.

12. The papers noted that hard data on the extent of the problem is variable and, in some cases, limited, which is in itself evidence of a wider systemic issue. However, overall, the following problems affect all of the three waters:

12.1 Weaknesses across the regulatory system. Both drinking water and environmental regulation exhibit, in differing degrees, inadequate stewardship, leadership, and compliance, monitoring and enforcement practices.

12.2 Funding and financing challenges. Three waters providers face a range of affordability issues and financial pressures. Many councils are struggling to fund plant and pipe infrastructure to the level required to meet standards and community aspirations, keep pace with population growth, and build resilience against natural events. Affordability challenges are particularly acute for smaller communities, rural and provincial councils, non-council drinking water suppliers, and marae. These communities are finding it difficult to afford quality infrastructure and services, especially within current structures and funding arrangements.

12.3 Capability and capacity challenges. Good capability is the key to meeting regulatory requirements, designing, procuring, delivering and managing three waters services, and undertaking complex public health and environmental risk assessments. However, it is often difficult for service providers to develop the capabilities required, and to access and retain people with specialist skills. These challenges tend to be greater for smaller rural and provincial councils, and non-council drinking water suppliers (such as small private and community schemes, and marae).

13. The Government Inquiry into Havelock North Drinking Water (Havelock North Inquiry) provided considerable evidence for reform. The Inquiry concluded that the problems in Havelock North are not confined to that area, and there is a widespread systemic failure of water suppliers to meet the high standards required to ensure the safe supply of drinking water to the public. If action is not taken, there are risks of similar incidents occurring elsewhere, with potentially serious consequences.

14. The events that led to the Havelock North contamination event in 2016, along with the findings of the subsequent Inquiry, have demonstrated that the existing system does not adequately safeguard against the risk of catastrophic contamination incidents, or drive improved compliance with the drinking water standards.

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2 The Department of Internal Affairs commissioned two reports to explore capability and capacity issues facing local government three waters providers – Castalia Ltd: *Three waters asset management maturity in New Zealand* (October 2017); and MartinJenkins: *Three Waters Review – interface between asset management and council governance* (December 2017).
15. The Inquiry also observed there is little understanding among the New Zealand public about the large numbers of people who consume unsafe drinking water. Every year, around 34,000 people become ill from their drinking water, and many more must boil their water to drink it safely. This has significant implications from a public health, economic, and cost perspective. (For example, the economic costs of the Havelock North waterborne disease outbreak were estimated at approximately $21 million.3)

16. Nationally, the estimated capital costs of upgrading networked drinking water treatment plants to meet drinking water standards is between $309 million and $574 million, with an additional annual operating cost of $11 million to $21 million.4

17. Council wastewater systems are also facing widespread challenges. Discharges from wastewater plants are affecting freshwater and coastal water quality, and sewage overflows are occurring at a frequency that is no longer acceptable for communities, including Māori. A high number of wastewater treatment plants are legally operating on expired consents for long periods of time. In many regions, regional councils do not (and are not required to) publish sufficient information to provide assurance about the impact of wastewater services on the environment.

18. Councils will face challenges to upgrade wastewater infrastructure. Research into the costs of upgrading wastewater treatment systems to meet potential national standards for freshwater and coastal discharges identified that the indicative costs of upgrading all wastewater treatment systems over the coming years falls within a range of $3.0 billion to $4.3 billion, with an additional annual operating cost of $126 million to $193 million.5

19. A significant portion of the costs to upgrade wastewater treatment systems will fall over the next decade. Just over 150 wastewater discharges from wastewater treatment plants will need new resource consents over the next 10 years.6 Upgrades to treatment plants are likely to be required to meet new consent requirements. The potential costs of those upgrades could be up to $2 billion7, with the costs of reconsenting estimated to be in the order of $100 million.

20. Many rural councils and their communities are struggling to meet the costs of upgrading wastewater treatment plants. The relative costs of wastewater upgrades for metro, provincial and rural councils create an affordability challenge for small, mostly rural councils. This affordability challenge is highlighted in the chart below.

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3 The Economic cost of the Havelock North August 2016 waterborne disease outbreak, by David Moore et. al. (August 2017), published on the Ministry of Health website.
4 Beca: Cost estimates for upgrading water treatment plants to meet potential changes to the New Zealand Drinking Water Standards, March 2018.
7 An estimate based on costs estimates developed by GHD, Boffa Miskell in reports referred to above.
21. Collectively, the problems outlined above contribute to the current weaknesses in the three waters regulatory and service delivery system. Taken together, they mean that we cannot always be confident that drinking water will be safe to drink, and that acceptable environmental outcomes are being achieved.

22. In addition, there will be broader national and local implications if performance improvements are not delivered across the three waters system, including:
   22.1 housing infrastructure supply being unable to meet demand in high-growth areas;
   22.2 failure to meet national and local environmental objectives for freshwater and the marine environment;
   22.3 a constrained ability to plan and fund robust systems that can cope with climate change, emergencies, and natural hazards;
   22.4 limitations on developing the regions, particularly for areas with declining rating bases, or small tourism centres with high seasonal demand.

**Additional challenges due to COVID-19**

23. The situation caused by COVID-19 means the local government sector is facing a series of additional issues and challenges, many of which relate to three waters services and infrastructure. COVID-19 will have significant impacts on local government finances, with consequences for council service delivery and infrastructure investment.

24. The Department of Internal Affairs has worked with Local Government New Zealand, the Society of Local Government Managers, the New Zealand Local Government Funding Agency, and the Treasury to understand the impacts of COVID-19 on local government finances, and the potential implications of this for infrastructure investment and council services.
25. While the impacts will be felt unevenly across New Zealand, it is already clear that all
councils will experience deterioration in their revenue and, in some cases, this will be
significant. An initial report has been prepared to provide an early analysis of these
impacts, which has been published on the Department’s website.\(^8\)

26. Prior to COVID-19, territorial authorities were planning on spending up to $8.3 billion
in capital over the next five years on water infrastructure. However, COVID-19 is likely
to cause significant decreases in revenue in territorial authorities over the short term.
Revenues could decline by between 10 per cent and 25 per cent over the next financial
year, and local authorities are facing increased cost pressures. As a result, borrowing
will be constrained due to lower debt limits that flow from lower revenues, and
opportunities to raise revenue through rates, fees and charges will be extremely
limited.

27. Previous behaviour indicates that investment in water infrastructure is an area where
councils have constrained spending in response to financial pressures. Investment in
water infrastructure is long term, and has a less visible impact on communities than
other forms of council expenditure.

28. The Three Waters Review has highlighted that New Zealand’s water infrastructure
already carries a burden of underinvestment. This is likely to worsen in response to
COVID-19, and could have serious consequences for the condition of water
infrastructure. We estimate that, in the absence of support from the Crown, territorial
authorities will face pressure to reduce planned capital investment in three waters
infrastructure by approximately $1.2 billion over the next three years.

29. A lack of investment in, and deterioration of, water infrastructure will perpetuate
some of the systemic problems identified above. This could also jeopardise the
effectiveness of the three waters regulatory reforms – if councils are unable to afford
to carry out the upgrades necessary to comply with drinking water regulatory
requirements, for example.

Reform objectives

30. The proposed objectives for reforming the three waters system have been prepared to
align and be consistent with previous objectives, including those in the recent Cabinet
paper, *Three waters service delivery and funding arrangements: approach to reform*
(January 2020). The objectives are:

30.1 significantly improving the safety and quality of drinking water services, and the
environmental performance of wastewater and stormwater systems (to deliver
widespread public health and environmental benefits);

30.2 ensuring all New Zealanders have equitable access to affordable three waters
services;

30.3 improving the coordination of resources and unlocking strategic opportunities
to consider New Zealand's infrastructure needs at a larger scale;

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30.4 increasing the resilience of three waters service provision to both short- and long-term risks and events, particularly climate change and natural hazards;

30.5 moving the supply of three waters services to a more financially sustainable footing, and addressing the affordability and capability challenges faced by small suppliers and councils; and

30.6 improving transparency about, and accountability for, the delivery and costs of three waters services, including the ability to benchmark the performance of service providers [CBC-20-MIN-0006 refers].

31. In January 2020, the Cabinet Business Committee noted that these objectives would be important considerations for the development of new service delivery arrangements. It also noted that, in addition to the specific objectives for reform, there are some bottom lines that any changes to service delivery arrangements must meet, including:

31.1 protecting public investment in three waters assets;

31.2 providing a customer voice;

31.3 accepting that change will have an impact on local government, but limiting the impact as much as possible.

32. In addition, objectives have been developed that relate to COVID-19 recovery – that is, to maximise the positive impact of the stimulus on local economies and jobs, and address the impact of the change process during transition. The Cabinet paper notes that the investment type and procurement support could be targeted at retaining local and lower skill jobs, preventing further deterioration in water infrastructure as council finances decrease, and avoiding investment in assets that may become stranded in future entities.

Options identification and analysis

33. Three Waters Ministers have been considering the potential for service delivery reforms for some time, and there have been prior Cabinet decisions on this topic. The latest paper proposes certain core components of the new service delivery model, thereby setting the basic direction for further policy development work and discussions with local government.

34. The proposed approach involves:

34.1 the creation of multi-regional, asset-owning water providers, which would be statutory entities;

34.2 protecting public ownership within new service delivery models and legislation, and developing ownership arrangements that involve local government.

35. The rationale for these proposals, and other alternatives that have been considered, is discussed below. This is based on advice that has been developed throughout the Three Waters Review.

36. As noted in the Cabinet paper, a large number of related matters would need to be explored further during policy development and design work, including:

36.1 shareholding arrangements;

36.2 funding and financing arrangements (including the fees and charges faced by consumers);
36.3 mechanisms that provide for local community input and local service delivery;
36.4 the nature and extent of the legislative framework that would be required to regulate the new entities, including economic regulation and mechanisms to protect consumer interests;
36.5 the scope of the new water entities’ remit, particularly regarding the provision of stormwater services, and drinking water and wastewater services that are currently the responsibility of private/community suppliers;
36.6 the potential use of instruments like government policy statements to guide/direct the new water entities.

37. These matters would be the subject of further advice and report backs, following detailed options identification and analysis, and stakeholder engagement. They are not considered in this document.

Approaches to service delivery reform

38. Previous Cabinet papers identified three potential approaches to service delivery reform:
38.1 voluntary, sector-led reforms to service delivery arrangements;
38.2 establishment of a three waters fund to support voluntary service delivery improvements; and
38.3 creation (in legislation) of an aggregated system of dedicated, publicly-owned drinking water and wastewater providers.

39. In January 2020, Cabinet Business Committee noted that the case for change to the current structural arrangements for the delivery of three waters services continues to build, and that changes to how New Zealand delivers three waters services are required.

40. At that time, it was agreed that central government would continue to support local government to make voluntary changes to service delivery arrangements, but set a one-year deadline for the sector to demonstrate progress. Work would also be undertaken in parallel to explore the other options identified above.

41. Since those decisions were made, the COVID-19 response and recovery work has led to a reconsideration of this process. The preferred approach is to move ahead with service delivery reform – through the creation of multi-regional, asset-owning water entities – coupled with Crown investment in water infrastructure. This is considered to be the most effective mechanism for achieving the dual goals and multiple objectives referred to earlier in this document.

42. Alternatives to the proposed approach were identified. For example, alternatives to the economic stimulus could include:
42.1 asking councils to fund further investments on their balance sheets, by utilising further borrowing;
42.2 supporting council debt through issuing some form of government bond;
42.3 using alternative funding or financing arrangements to support further investment in three waters assets, such as Special Purpose Vehicles (SPVs).
43. We also considered whether economic stimulus could accompany voluntary service delivery reform, or could be unconditional.

44. These options were assessed in terms of their feasibility and effectiveness in meeting the dual goals and objectives. Considerations included the likelihood the goals/objectives will be met, the nature and extent of the effect/impact, timeliness, and certainty of outcome.

45. None of the alternative approaches were considered to be as effective as the proposed approach. In summary:

45.1 Asking councils to fund further investments on their balance sheets, by utilising further borrowing, is unlikely to be effective and would not bridge the expected investment gaps. The decrease in revenues will severely constrain councils’ ability to take on more debt, and mean most councils will need to curtail almost all of their borrowing programmes. We estimated that, in aggregate, councils will only be able to borrow an additional $40 million per annum without breaching debt-to-revenue limits. This is insufficient to bridge the expected $3 billion investment gap.

45.2 Supporting council debt through issuing some form of government bond is only an attractive option if the differential is large and councils have a greater ability to take on debt than current circumstances allow. Overall, the likelihood of this occurring is low, and unlikely to be sufficiently attractive to the sector nor sufficient to prevent deterioration of the infrastructure.

45.3 There are several challenges with using SPVs, particularly from an immediate response perspective, and they would not incentivise structural reform. SPVs are not well-suited to brown-field development or renewal of assets, which is what the bulk of this programme of work is looking to support in the short to medium term. SPVs also typically rely heavily on private or overseas equity investment to fund up-front capital costs. Due to the economic shock relating to COVID-19, it is likely that ready access to private equity and capital will be limited, and the Crown will need to step in to help fill this gap in the short term. Even in instances where private equity is available, borrowing costs are likely to escalate substantially for firms to access this form of capital.

45.4 Evidence to date suggests that the political and economic barriers to voluntary reforms are high. Proceeding with a voluntary approach to service delivery reform, or unconditional investment, would not guarantee that reform will occur or be achieved in a way that meets the objectives. This would not represent a sound investment approach or good use of public money.

**Number of entities**

46. The preferred approach involves the creation of a small number of multi-regional water service providers, which would be asset-owning.

47. It is anticipated that this would realise a number of economic and other benefits associated with large scale providers, address the many of the systemic issues and infrastructure deficits facing the three waters system, and help to deliver the reform objectives. Benefits include:
47.1 increased financial capacity and capability, with stronger, more flexible and resilient balance sheets, greater access to capital, and a more reliable investment pipeline;

47.2 opportunities to take a strategic and coordinated approach, to consider infrastructure needs at a larger scale and in the context of wider catchment outcomes;

47.3 building technical capabilities, with access to a larger, more specialist workforce, and the ability to innovate and make use of new technology;

47.4 enabling financial efficiencies and lower operating costs, by consolidating administration and overhead costs, and improving organisational capabilities;

47.5 enabling more consistent water charges, with the ability to harmonise tariffs across much larger areas.

48. Many of these benefits are only realised (fully or partially) if the new entities are asset-owning. Shared services models that do not involve asset ownership have a number of shortcomings, including the inability to access scale or scope efficiencies, and split accountabilities.

49. Wellington Water is a current example of a shared-service council-controlled organisation that manages and operates drinking water and wastewater assets and services for its council owners. However, each of the councils continue to own water assets and raise revenue (on advice from Wellington Water) for the operation, maintenance and, where necessary, the upgrade of those assets. Wellington Water has no ability to make trade-offs between operating and capital expenditure, nor can it cross-subsidise between owners or ratepayers in different districts.

50. How many multi-regional water providers would be created, and their boundaries, is a matter for discussion between Ministers and local government. However, it is proposed that final decisions on these matters would be based on the following factors:

50.1 scale benefits – including at least one very large urban centre within each entity, to ensure the full benefits of scale are achieved through a larger network and population base;

50.2 communities of interest;

50.3 relationships with other jurisdictional boundaries, including catchments.

51. The table below presents a summary of previous analysis on options for the approximate number of entities, and the strengths and weaknesses of different approaches.
### Strengths

<table>
<thead>
<tr>
<th>16 regional, publicly-owned water providers</th>
<th>Small number of multi-regional, publicly-owned water providers (e.g. 3-5) (PREFERRED)</th>
<th>1 national, publicly-owned water provider</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Alignment with catchments</td>
<td>• Large scale operations and population coverage – big urban base in each area</td>
<td>• Largest scale operations and concentration of expertise</td>
</tr>
<tr>
<td>• Regional identity</td>
<td>• Bigger balance sheets – all areas could be self-funding/sustainable; leverage greater debt</td>
<td>• Biggest population coverage and balance sheet</td>
</tr>
<tr>
<td>• Continued territorial authority ownership is possible</td>
<td>• Several similar providers – enables benchmarking</td>
<td>• Could leverage greater debt (though not significantly more than larger-scale multi-regional providers)</td>
</tr>
</tbody>
</table>

### Weaknesses

<table>
<thead>
<tr>
<th>16 regional, publicly-owned water providers</th>
<th>Small number of multi-regional, publicly-owned water providers (e.g. 3-5) (PREFERRED)</th>
<th>1 national, publicly-owned water provider</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Relatively small-scale operations and balance sheets in many regions</td>
<td>• Harder to reflect local identity (if appropriate) – though service delivery could still have a local presence</td>
<td>• Requires more onerous regulation</td>
</tr>
<tr>
<td>• Very different population sizes and resources – consistency and benchmarking difficult</td>
<td>• May be less desirable to local government than a regional approach</td>
<td>• Benchmarking is not possible (so we will not know how well it is performing)</td>
</tr>
<tr>
<td>• Some regions will continue to struggle with funding and infrastructure challenges (e.g. if they are small, spread out, and/or have no large urban base)</td>
<td>• Though service delivery could still have a local presence</td>
<td>• May need to be Crown owned; harder to provide for council ownership</td>
</tr>
</tbody>
</table>

52. As the table indicates, there are concerns about the feasibility and viability of a purely ‘regional’ model (that is, 16 providers within current regional council / unitary authority boundaries). The reference to ‘scale benefits’ in the assessment factors listed above is intended to address this point.

53. The January 2020 Cabinet paper noted that regions with low density or no large urban base and a relatively small ratepayer base would continue to face affordability challenges. This was illustrated in the chart below, which identifies the costs per ratepayer in each region for the capital costs of wastewater upgrades.
54. There is a risk that rural regional water service providers with smaller populations will struggle financially and continue to underinvest in three waters infrastructure. Smaller regions are also less likely to be able to take advantage of new technologies, or meet goals such as carbon neutrality.

55. The significant difference in the size and scale of different regional water service providers would make benchmarking difficult. There are also likely to be higher regulatory costs due to the significant number of providers and the large variation between them.

56. The alternative option of one, national water provider is also not a preferred option. This has a number of weaknesses, relative to the preferred multi-regional provider model. In January 2020, Cabinet Business Committee agreed that further work with local government on the design of new service arrangements would focus on multi-regional and regional models for service delivery. This effectively ruled out a single provider as an option.

**Statutory entities**

57. The preferred approach is that the new multi-regional water providers would be statutory entities. This would require legislation.

58. Statutory entities have boards, but are not companies. Each statutory entity usually has its own establishing legislation that contains entity-specific objectives that could be a mix of social, cultural, public policy, or commercial. Statutory entities can have non-commercial functions or commercial imperatives.

59. The main alternative to this approach would be for the new multi-regional providers to be council-controlled organisations (CCOs). This is an organisational form that is provided for in the Local Government Act 2002, and which is used regularly by local authorities.
However, we consider that this option has a number of disadvantages and drawbacks, and would not be effective in achieving the benefits sought from multi-regional models. For example:

60.1 Current provisions in the Local Government Act are not fit for this purpose, and present barriers to reform. It is likely to take as long to redesign and amend the existing legislative provisions, as it would to create bespoke provisions in new legislation (including some form of economic regulation).

60.2 Establishing CCOs requires the agreement of all councils, each of which would need to undertake public consultation. This would take time and creates uncertainty about the outcome.

60.3 If the new entities were CCOs, this is likely to have implications for financing arrangements. They may not be sufficiently separate from local government to borrow at similar rates as other utilities, for example.

Public ownership

61. Throughout the Three Waters Review, there has been a clear and explicit ‘bottom line’ about public ownership.

62. On 5 November 2018, Cabinet agreed that the outcome of three waters reforms would include that “existing three waters assets and services must remain in public ownership, and the system will incorporate safeguards to protect public ownership of this essential infrastructure, both now and in the future” [CAB-18-MIN-0545 refers].

63. This decision is supported by the noting recommendation in January 2020 referenced earlier in this document, and recent discussions with Three Waters Ministers.

64. The Department strongly agrees with this position, and has not identified or assessed alternative options. There are significant disadvantages and risks associated with privatisation, and no clear benefits. There would be extensive public and local government opposition to privatisation.

65. Evidence from overseas indicates that most of the similar jurisdictions that have successfully reformed their water service delivery arrangements have created publicly-owned entities. For example, Scottish Water is owned by the Scottish Government, while Tasmania Water (TasWater) is owned by local authorities and the Tasmanian Government.

66. There would be various ways of structuring a public ownership model. The proposed approach involves local government collective ownership of the new service delivery entities, through local authority shareholders. This is the preferred approach, given local government currently owns the water assets that would be transferred to the new entities. This would enable local authorities to continue to have a strategic oversight role in relation water services, and maintain a link with other council responsibilities and local communities.

67. The basis for shareholding will need careful consideration and financial analysis. It could be possible to apportion shares on the basis of the condition of the assets that are transferred, to reward previous investment and good asset maintenance. There could also be potential to provide for some form of annual return to shareholders/councils.
68. There are also opportunities to consider other shareholding and investment arrangements. Further policy development work would examine the potential for:

68.1 the Crown to be a shareholder (for example, in recognition of stimulus funding);
68.2 other investors to be party to financing (but not ownership/equity) arrangements.

69. There would be further advice to Three Waters Ministers on these matters, and proposals would be in later Cabinet papers.

70. We note that the possibility for third party equity arrangements – such as ACC and New Zealand Super – was ruled out by Three Waters Ministers earlier in the Three Waters Review. This was because these kinds of organisations need to be able to maximise the return on their investment, and may need to release the equity at any time. This was considered to be undesirable, and incompatible with Cabinet decisions that water services must remain in public ownership. Wider (private) equity arrangements have been ruled out on the same basis.

71. The potential for iwi investment was left as a possibility, though, and will be explored further in future advice.

Department of Internal Affairs

May 2020