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Hon Nanaia Mahuta, Minister of Local Government

Proactive release of Cabinet material related to progressing the
three waters service delivery reforms, 14 December 2020

The following documents have been proactively released:

14 December 2020, CAB-20-MIN-0521.01 Minute: Progressing the Three Waters Service Delivery Reforms, Cabinet Office; and

14 December 2020, Cabinet Paper: Progressing the three waters service delivery reforms, Office of the Minister of Local Government.

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) – to maintain the constitutional conventions for the time being which protect the confidentiality of advice tendered by Ministers of the Crown and officials, including the redaction of Budget Sensitive material; and
- 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions by or between Ministers.

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Cabinet

Minute of Decision

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Progressing the Three Waters Service Delivery Reforms

Portfolio(s) **Local Government**

On 14 December 2020, following reference from the Cabinet Business Committee, Cabinet:

Context and progress update

- 1 **noted** that New Zealand's three waters system is facing a number of significant challenges, and will continue to do so without major, transformational reform of service delivery arrangements;
- 2 **noted** that in July 2020, the government announced a \$710 million waters-related funding package to support economic recovery relating to COVID-19, and to address persistent issues facing the three waters sector, through a combination of infrastructure investment stimulus and service delivery reform [CAB-20-MIN-0328.13];
- 3 **noted** that since then, a comprehensive service delivery reform programme (the reform programme) has been established by the Department of Internal Affairs, which is progressing well, including:
 - 3.1 rolling out stimulus funding of \$523 million, in instalments, to every eligible council;
 - 3.2 developing and implementing a large-scale, multi-faceted work programme;
 - 3.3 setting up and supporting a Joint Central/Local Government Three Waters Steering Committee (the Joint Steering Committee);
 - 3.4 engaging and communicating with local government and iwi/Māori through a series of initial workshops, hui-ā-motu, and webinars;
- 4 **noted** that there will be continued engagement with iwi/Māori throughout the reform programme, including to ensure the Crown delivers on its obligations relating to the Treaty of Waitangi;
- 5 **agreed** that a high-level principle of partnership with iwi/Māori will be followed throughout the reform programme, and reflected in the new three waters service delivery system;

Confirming critical details of the future reform strategy and timetable

6 **noted** that:

- 6.1 on 3 June 2020, the Cabinet Economic Development Committee agreed to the high-level approach to reforming three waters service delivery over a three-year period [DEV-20-MIN-0079];
- 6.2 many of the details involved in delivering this approach had not been fully developed at that time;

7 **noted** that it is imperative to set an ambitious timeframe for this reform programme, and to confirm critical details of the preferred reform strategy and timetable, to enable it to continue at pace;

8 **agreed** that the reform timetable include the following key milestones:

- 8.1 substantive policy decisions relating to the reforms in April/May 2021, to enable drafting instructions to be issued, including decisions on:
 - 8.1.1 the core design features of the new water services entities and system;
 - 8.1.2 the number and boundaries of the new water services entities;
- 8.2 introduction of legislation to create the new service delivery system in late 2021, and enactment by mid-2022;
- 8.3 transition, entity establishment, and implementation of the new service delivery system from 2022/23;

9 **noted** that the reform programme currently involves a voluntary, partnership-based approach with the local government sector, and that:

- 9.1 continuing with a voluntary approach has a number of benefits, as well as some risks and challenges;
- 9.2 an alternative approach, in which council participation in the reforms and asset transfer is mandated by legislation, also carries considerable risk;
- 9.3 a voluntary approach is only likely to be achievable and effective in conjunction with a number of other factors, including the use of:
 - 9.3.1 a nationwide public information and education campaign;
 - 9.3.2 9(2)(f)(iv) incentives to encourage council participation in the reforms;
 - 9.3.3 early legislation to enable councils to consult and make decisions on participation in the new service delivery system;

10 **agreed**, 9(2)(f)(iv) to continue to take a voluntary approach to reform, in which:

- 10.1 councils would be asked to decide to participate in the new service delivery system in late 2021;

- 10.2 this decision would be in the form of an 'opt out' approach, whereby all affected councils would be included in one of the new water service delivery entities by default, but can decide not to continue to participate;
- 10.3 central government would provide councils with detailed proposals and a package of supporting information ahead of the decision-making window, including details on:
- 10.3.1 entity design proposals, such as ownership, governance, control, and accountability arrangements;
 - 10.3.2 the financial and other implications of participating in the proposed new service delivery system, including any applicable 9(2)(f)(iv) incentives;
 - 10.3.3 which water services entity each council would be part of, and its boundaries;
- 11 **agreed** that central government will use a nationwide public information and education campaign to provide a national picture of the case for change and build support for the reforms;

12 9(2)(f)(iv)

Confirming the process for identifying the number of new water services entities

- 13 **noted** that the paper considered by Cabinet in June 2020 [DEV-20-SUB-0079] reflected Ministerial preferences for the creation of a small number of large-scale water service entities, which would be separate from local authorities, pending further discussions with Ministers and local government about the exact number of entities and their boundaries;
- 14 **noted** that there is a need to confirm the process that will be used to identify the number of entities and their boundaries, so this process can be communicated to the local government sector and iwi/Māori;
- 15 **agreed** to proceed with a centrally-led process for identifying the number of entities and their boundaries, in which:
- 15.1 a shortlist of options is identified, based on analysis of key factors such as achieving scale benefits, communities of interest, and relationship with other boundaries, including catchments;
 - 15.2 there is engagement on this shortlist of options with the local government sector and iwi/Māori in March 2021;
 - 15.3 proposals for the final number and boundaries of entities, and which entity each council would be part of, are considered by Cabinet in April/May 2021, followed by the preparation of legislation to give effect to the decisions made;
- 16 **noted** that the options referred to in paragraph 15 above will be developed by the Minister of Local Government, in consultation with other Three Waters Ministers (these being the Ministers of Finance, Infrastructure, Housing, Commerce and Consumer Affairs, Environment, Rural Communities, Climate Change, Health, and Economic and Regional Development) and the Joint Steering Committee;

- 17 **noted** that decisions about the number of entities will be connected to considerations about equity of pricing and equity of access to services, and that there will be further discussions with Three Waters Ministers about these matters in early 2021, when more data and analysis become available;

Early direction on entity design scenarios to be tested with credit rating agencies

- 18 **noted** that independent, competency-based governance of water services entities is critical to realising the benefits of reform, and that balance sheet separation from councils is needed to provide entities with the financial capacity to meet the infrastructure deficit and future investment needs;
- 19 **agreed** that the proposed water services entities will have:
- 19.1 financial and operational autonomy, including independent and competency-based governance arrangements;
 - 19.2 a commercial objective, among other objectives;
- 20 **noted** that officials are continuing to explore collective council ownership options that meet the reform objectives, including statutory entities on a shareholding or non-shareholding ownership basis, consistent with directions in the paper considered by Cabinet in June 2020 [DEV-20-SUB-0079];
- 21 **noted** that officials will also consider options for Crown and iwi/Māori interests in the new water services entities;
- 22 **noted** that local authorities may seek influence in areas of strategic direction, governance and strategic planning, and that officials will test various levers and levels of influence with credit rating agencies in early 2021;

Early direction regarding economic regulation

- 23 **noted** that economic regulation plays a critical role in protecting consumer interests and providing high-quality performance information that supports other important players in the three waters system;
- 24 **agreed in principle**, subject to further reports to Cabinet, that an economic regulation regime will be employed in a reformed New Zealand three waters sector;
- 25 **noted** that, all else being equal, economic regulation will be able to provide greater and more effective oversight, the smaller the number of regulated water services entities;
- 26 **agreed in principle**, subject to further reports to Cabinet, that an information disclosure regime that allows the performance of entities to be compared will apply, at a minimum, to a substantively reformed three waters sector;
- 27 **noted** that whether or not stronger forms of economic regulation, such as price-quality regulation, should also be employed will depend on the number of reformed water services entities and their governance arrangements;

Financial implications

28 **noted** that on 6 July 2020, as part of the COVID-19 Response and Recovery Fund July Package, Cabinet:

28.1 agreed that up to \$710 million be available for the three waters reform programme, including:

28.1.1 an investment package of up to \$701.940 million to support local government to maintain planned investment and asset quality, and support large-scale asset replacements and the bringing forward of “no regrets” investment in the latter part of the reform programme;

28.1.2 up to \$8.060 million in departmental funding to meet the costs associated with the initial implementation of the three waters reform programme;

28.2 agreed to set aside an operating contingency of \$710 million for the three waters infrastructure investment and service delivery reform programme, indicatively phased in 2020/21 with corresponding funding charged against the COVID-19 Response and Recovery Fund;

28.3 authorised the Minister of Finance, Minister of Local Government, Minister for Infrastructure, Minister of Internal Affairs, and any other relevant appropriation Ministers (Joint Ministers), to jointly draw down the contingency referred to above (the three waters contingency);

[CAB-20-MIN-0328.13]

29 **noted** that the reform programme is only partially funded and faces cost pressures of \$7 million in 2020/21, driven by additional policy, commercial and legal advisory support, substantial engagement activity, and support for the Society of Local Government Managers and councils to engage with the reform programme;

30 **noted** that an investment of 9(2)(f)(iv) (\$2 million in 2020/21 9(2)(f)(iv)) is required to undertake a public information and education campaign directed to provide a national picture of the case for change and to build wider community support for the reforms;

31 **noted** that the reform programme is unfunded after 30 June 2021;

32 9(2)(f)(iv)

33 **noted** that \$148.8 million of the three waters contingency is currently unallocated;

34 **agreed** that a further 9(2)(f)(iv) of the unallocated portion of the three waters contingency be allocated as follows:

34.1 \$9 million to programme costs for the remainder of 2020/21 to address the current cost pressures and commence the public information campaign;

34.2 9(2)(f)(iv) departmental funding to support the continued delivery of the reform programme in 2021/22 and 2022/23, and to further progress the public information and education campaign;

35 **agreed** to extend the scope of the three waters contingency to include departmental programme costs, the public information and education campaign, and support for the local government sector to engage with the reform programme;

36 **rescinded** the decisions in paragraphs 20.1 and 20.2 of CAB-20-MIN-0328.13, referred to in paragraphs 28.1.1 and 28.1.2 above, to give effect to paragraph 34 above;

37 9(2)(f)(iv)

[REDACTED]

[REDACTED]

38 **agreed** to extend the expiry date of the three waters contingency from 1 March 2021 to 1 March 2022, to align with the timeframes agreed with councils through their Delivery Plans and Funding Agreements;

39 **agreed** to draw down \$9 million from the three waters contingency, to address the programme cost pressures described in paragraph 29 above, and to commence in 2020/21 the public information and education campaign referred to in paragraph 30 above;

40 **approved** the following change to appropriations to provide for paragraph 39 above, with corresponding impact on the operating balance and net Crown debt:

Vote Internal Affairs Minister of Local Government	\$million – increase/(decrease)				
	2020/21	2021/22	2022/23	2023/24	2024/25 & Outyears
Department Output Expense: Local Government Policy and Related Services (funded by revenue Crown)	9.000	-	-	-	-

41 **agreed** that the change to appropriations for 2020/21 above be included in the 2020/21 Supplementary Estimates and that in the interim the increase be met from Imprest Supply;

42 **agreed** the expenses incurred under paragraph 40 above be charged against the three waters contingency;

43 **noted** that:

43.1 there is inherent uncertainty around the timing of releasing the remaining stimulus funding to councils, as this is based on achieving agreed milestones;

43.2 there is uncertainty about the timing of approval of the rural drinking water supplies' package and the overall timing of the departmental programme costs;

44 **noted** that on 6 July 2020, Cabinet agreed that any and all underspends related to the initiatives approved in the COVID-19 Response and Recovery Fund (CRRF) July Package be returned to the CRRF, until it ceases to exist, at which point they be returned to the centre [CAB-20-MIN-0328.13];

45 **agreed** that any unspent funds in 2020/21, which result from the delay in councils delivering milestones in their Delivery Plans, or have been committed to by Joint Ministers for programme funding and rural drinking water supplies, are not considered underspends for the purposes of the decision referred to in paragraph 44 above;

Legislative implications

46 **noted** that, if there is agreement to continue to take a voluntary approach to reform, under paragraph 10 above:

46.1 councils would be asked to decide to participate in the new service delivery system in late 2021; and

46.2 giving effect to a decision to participate would involve transferring council water infrastructure and service delivery responsibilities to new water service entities in around 2023/24;

47 **noted** that there are a number of provisions in the Local Government Act 2002 (LGA02) that create statutory obstacles for councils to make these decisions, or may make it difficult to achieve a desirable outcome from a local government and central government perspective, including:

47.1 provisions that oblige councils to maintain water services, and prohibit them from divesting ownership of these services, or from selling, transferring, or losing control of the infrastructure needed to provide water services;

47.2 provisions relating to consultation, long-term planning, and decision making that would apply due to the significance of a decision of this kind;

48 **noted** that if a voluntary approach to reform is to work, these statutory obstacles will need to be addressed through legislative amendments to the LGA02;

49 **noted** that the Local Government (Three Waters Reform) Amendment Bill will:

49.1 address the statutory obstacles in local government legislation that prohibit councils from divesting ownership of, or control over, water infrastructure assets and services, but only for the purposes of making a decision to participate in the government's reform proposals to create new water service entities;

49.2 remove or amend the detailed legislative requirements in local government legislation relating to council consultation, long-term planning, and decision making for the purposes of making a decision to participate in the government's reforms;

49.3 provide a fit-for-purpose consultation process, based on the provisions in the LGA02, which sets out how local government would engage with communities and iwi/Māori about the reform proposals, and make decisions;

50 **noted** that the Minister of Local Government will seek a category 2 priority for the Local Government (Three Waters Reform) Amendment Bill on the 2021 Legislation Programme (must be passed in 2021);

51 **invited** the Minister of Local Government to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above proposals;

52 **noted** that drafting instructions will be provided to the Parliamentary Counsel Office by 1 February 2021;

- 53 **noted** that the Local Government (Three Waters Reform) Amendment Bill should be introduced no later than 1 April 2021, and passed no later than 1 November 2021;
- 54 **authorised** the Minister of Local Government to approve matters of detail consistent with policy that may arise during the course of drafting, including any consequential amendments to other legislation that may be required;
- 55 **agreed** that technical experts from the local government sector and iwi/Māori can be consulted, if needed, during the drafting process.

Michael Webster
Secretary of the Cabinet

***Secretary's Note:** This minute replaces CBC-20-MIN-0109. A Cabinet minute has been issued for this item as it involves rescinding previous Cabinet decisions (see paragraph 36).*

Proactively released by the Minister of Local Government

Office of the Minister of Local Government

Chair
Cabinet Business Committee

Progressing the three waters service delivery reforms

Proposal

1. This paper seeks decisions on several critical issues relating to the three waters service delivery reform programme (the reform programme), namely:
 - 1.1 the key components of the reform strategy and timetable;
 - 1.2 continuing with a voluntary approach to reform;
 - 1.3 agreement to introduce legislation needed to facilitate a voluntary approach, by enabling and supporting councils to make decisions to participate in the new service delivery system;
 - 1.4 the process for identifying the numbers and boundaries of new water services entities;
 - 1.5 the entity design scenarios that would be tested with credit rating agencies;
 - 1.6 programme funding.
2. Decisions and directions on these matters are requested now to enable the reform programme to continue to proceed at pace.

Relation to government priorities

3. In April 2019, it was agreed that the Three Waters Review is a Government priority. The 2020 Labour Party Manifesto committed to reform New Zealand's drinking water and wastewater system, and upgrade water infrastructure to create jobs across the country.

Executive summary

4. New Zealand's three waters system is facing a number of significant challenges, and will continue to do so without major, transformational reform. Latest estimates indicate that the size of the infrastructure deficit facing local government water service providers is in the order of \$30 billion to \$50 billion, against an annual spend of around \$1.5 billion. Eliminating this deficit could take 30 years, and will be beyond the funding and operational capacity of most councils and communities under current arrangements.
5. We have an opportunity to address this situation by reforming three waters service delivery arrangements, to create a small number of large-scale water entities, with sufficient balance sheet capacity to raise debt to fund these investment requirements. This would deliver the necessary infrastructure upgrades at a lower, more efficient cost to households than under current delivery and funding arrangements.

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6. In July 2020, the Government announced a \$710 million funding package to support economic recovery relating to COVID-19, and to start to address the persistent issues facing the three waters sector, through a combination of infrastructure investment stimulus and service delivery reform. Councils that agreed to participate in the initial phase of the reform programme were eligible to receive a share of this funding package.
7. Since then, a comprehensive service delivery reform programme has been established by the Department of Internal Affairs, and is progressing well – using a partnership approach between central and local government. Stimulus funding totalling \$523 million is being provided to every eligible council, in instalments. Of this, approximately 44 per cent (by value) has been attributed to drinking water infrastructure, 39 per cent to wastewater, and 10 per cent to stormwater. Based on council reporting, the stimulus funding is expected to generate approximately 2000 jobs across New Zealand.
8. To maintain momentum with the reforms, it is imperative that we continue to work to an ambitious timeframe. As indicated in the diagram at **Appendix A**, I am proposing that:
 - 8.1 substantive policy decisions are made in April/May 2021 – to enable drafting instructions to be issued;
 - 8.2 legislation to create the new service delivery system is introduced in late 2021 and enacted by mid-2022 (prior to the local government elections);
 - 8.3 transition, entity establishment, and implementation occur from 2022.
9. Achieving these milestones means we need to provide early direction on critical details of our preferred reform strategy and key components of the reform programme. Key decisions sought through this paper relate to:
 - 9.1 whether to continue to proceed with a voluntary approach, and the likely benefits, challenges, risks and incentives associated with this approach;
 - 9.2 agreement to introduce legislation, ahead of the main reform programme, to enable and support councils to consult and make decisions on participation in the new service delivery system;
 - 9.3 how council decisions would be ‘framed’ – with the preference being for an ‘opt out’ approach, in which the starting position is that all councils would be included in one of the new water services entities, unless they decide not to participate in the reforms and opt out;
 - 9.4 communications and engagement, including the role of central government in presenting a national picture of the case for change, and undertaking a public information and education campaign;
 - 9.5 the approach to identifying and agreeing the number and boundaries of new entities – with a preference for a centrally-led process;
 - 9.6 how to work with iwi/Māori – as our Treaty partners – throughout the reform programme, and ensure their rights and interests are reflected appropriately;
 - 9.7 the entity design options and key features that would be tested with credit rating agencies.

10. Developing and delivering the reforms involves a large and complex work programme, specialist commercial, legal and policy resources, substantial engagement with the local government sector and iwi/Māori, and support for the Joint Central/Local Government Three Waters Steering Committee (Joint Steering Committee) that was established to oversee the reforms. The ability to continue to deliver the programme, and to do so at the necessary pace, is subject to ongoing funding.
11. The reform programme has only been partially funded, and the Department of Internal Affairs is facing significant funding pressures. The Department has been appropriated \$8.06 million in 2020/21, but is forecast to spend an additional \$7 million by 30 June 2021, and is unfunded for future years. The Department is unable to reprioritise such significant cost pressures within baseline funding.
12. In addition, I have requested that officials prepare a nationwide strategic communications strategy to socialise the benefits of reform with ratepayers. Further cost pressures would be created in order to proceed with a national public information campaign, which is an important part of the reform strategy.
13. A portion (\$148.8 million) of the operating contingency that was established for the *Three Waters Infrastructure Investment and Service Delivery Reform Programme*, is currently unallocated. This provides a potential avenue for funding these cost pressures within the \$710 million already committed by Cabinet, and in line with the outcomes sought.
14. The Treasury has advised that accessing the operating contingency for programme costs would require an extension of the scope of this contingency, and agreement by Cabinet. I am seeking these decisions through this paper.
15. I am also seeking agreement to an in-principle transfer of any underspend in the appropriation, to reflect agreements with councils that any stimulus funding must be spent by 31 March 2022. This will help to manage the uncertainty around the timing for releasing instalment payments to councils. By the end of November 2020, the Department was forecast to pay \$261.5 million to councils (equating to 50 per cent of eligible funding). Subsequent instalments will be released on the achievement of milestones linked to the completion of defined activities.

Background

16. Over the past three years, I have been leading the cross-government Three Waters Review. Through this work, we are seeking to address a complex set of issues relating to the regulation, funding, financing, and provision of drinking water, wastewater, and stormwater services (the three waters), and to deliver better outcomes for New Zealand's people, environment, and economy.
17. Core outcomes include: safe, affordable drinking water; improved environmental performance of wastewater and stormwater networks; infrastructure to support housing and economic development; addressing infrastructure deficits and resilience issues; and improved efficiency of service delivery, with benefits for investment, jobs, and productivity.

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18. The regulatory reforms – which were a large part of our initial focus – are progressing well. Legislation has been enacted to create Taumata Arowai, the water services regulator, and work to establish this new Crown agent is underway within the Department of Internal Affairs. A separate Water Services Bill, containing the new regulatory framework that Taumata Arowai will administer, is awaiting its first reading.
19. Strengthening the regulatory framework for drinking water, wastewater and stormwater quality is an essential first step to improving the three waters system. However, the regulatory reforms are unlikely to be successful unless they are accompanied by the restructuring of service delivery arrangements necessary to address other critical issues facing three waters services. Likewise, the success of service delivery reform is contingent on the regulatory framework being clear and fit for purpose, and Taumata Arowai being equipped with the right regulatory strategy, tools and resources.
20. Both central and local government have acknowledged there are many challenges facing our water services, and the communities that fund and rely on these services. In particular, a significant infrastructure deficit is resulting in poor quality infrastructure, substandard network performance, and higher than necessary costs of delivery.
21. In July 2020, the Government announced a \$710 million funding package to support economic recovery relating to COVID-19, and address persistent systemic issues facing the three waters sector, through a combination of:
 - 21.1 stimulating investment, to assist economic recovery through job creation, and maintain investment in water infrastructure renewals and maintenance; and
 - 21.2 reforming current water service delivery arrangements into larger-scale entities – to realise significant economic, public health, environmental, and other benefits over the medium to long term.
22. The Cabinet paper that preceded this announcement (the June 2020 paper), signalled some of our minimum expectations, objectives, and starting intentions for the service delivery reforms.¹ This included:
 - 22.1 in-principle agreement to the creation of a small number of new multi-regional water service providers, which would be statutory, asset-owning entities;
 - 22.2 a preference that the new entities would be collectively owned by local authorities, but with legal and financial separation, and a competency-based board;
 - 22.3 confirmation that there would be safeguards against privatisation, and mechanisms that provide for continued public ownership, community input, and local service delivery.
23. Final decisions on a service delivery model are to be informed by more detailed policy, legal and commercial work, and engagement with local government and iwi/Māori. The Department of Internal Affairs is leading this work programme and engagement, overseen by a Programme Board.²

¹ *Investing in water infrastructure to accelerate reform and support economic recovery post COVID-19*, June 2020 [DEV-20-SUB-0079 refers].

² The Programme Board is led by the Chief Executive of the Department of Internal Affairs, and includes senior officials from The Treasury, Te Arawhiti, and Taumata Arowai.

24. The service delivery reforms were conceived of as a three-year, multi-phase programme, with the potential for further tranches of funding. The initial phase involves an 'opt in', good faith approach with councils, and the provision of funding from the stimulus package to those councils that decided to participate.
25. The work to date has been predicated on a shared understanding between central and local government that a partnership approach will best support wider community interests, and ensure that any transition to new service delivery arrangements is well managed and as smooth as possible.
26. To reflect this understanding, a Joint Steering Committee, comprising central and local government representatives, has been formed to provide oversight and guidance on service delivery reform.³
27. A group of Three Waters Ministers⁴ will continue to provide direction and support across this work. I have already met with this group for an initial discussion about the substantive matters in this paper, and anticipate having regular meetings throughout 2021 as we develop and roll out the reform proposals. This approach will also enable strategic connections to be made between this work and other reform programmes, such as the proposed changes to the resource management system, which are likely to amend planning and consenting arrangements for water and infrastructure.

Analysis

Stimulus funding of \$523 million is being rolled out to every eligible council

28. Every eligible council decided to participate in the initial phase of the reform programme, and signed the Memorandum of Understanding (MoU) with the Crown by the deadline of 31 August 2020. Funding is now being distributed to those councils, in accordance with approved Delivery Plans and Funding Agreements.
29. Of the \$523 million available in stimulus funding, approximately 44 per cent (by value) has been attributed to potable water infrastructure, 39 per cent to wastewater infrastructure, 10 per cent to stormwater infrastructure, two per cent toward advisory services on reform, and five per cent on other related infrastructure (water storage and network management). A further \$30 million has been allocated to support rural drinking water supplies.
30. By the end of November 2020, the Department of Internal Affairs was forecast to pay \$261.5 million to councils. Subsequent instalments will be released to councils on the achievement of milestones linked to completion of defined activities, which will be agreed between the Department, Crown Infrastructure Partners, and each council by the end of January 2021.

³ The Joint Steering Committee comprises Mayors, Chief Executives, and regional council representation, as well as the Society of Local Government Managers, Local Government New Zealand, the Department of Internal Affairs, the Ministry of Business, Innovation and Employment, and the Treasury.

⁴ This is an informal group currently comprising the Ministers of/for Finance, Infrastructure, Housing, Commerce and Consumer Affairs, Environment, Rural Communities, Climate Change, Health, and Economic and Regional Development.

31. The insights gained through a review of council Delivery Plans reinforces the service delivery reform programme and case for change. Delivery Plans revealed that many councils have under-invested in three waters infrastructure, either due to historical underfunding, poor service delivery, a lack of engineering capability or capacity, or the lack of a sustainable funding model to support such investment. It is evident across the sector that there are a lack of economies of scale and scope, due to the small size of some of the water utility operations within many councils.
32. Given the high public interest in the programme, a quarterly report will be published on the progress of councils against their Delivery Plans, and outcomes that have been achieved. This is consistent with Open Government protocols.
33. Signing the MoU commits councils to engage with the reform programme and share information on their three waters assets, but does not legally require them to continue with future stages of the reforms. Officials are currently implementing a 'request for information' (RFI) process to gather this information, and are supporting councils to comply with this request. Given the work associated with the RFI, councils may re-allocate up to \$60,000 of their stimulus funding allocation to help them to respond.
34. The RFI process represents a major undertaking by the local government sector to improve the state of knowledge and understanding about three waters assets, network performance, service delivery costs, commercial arrangements, and future investment requirements.
35. Analysis of the data acquired through this process is being undertaken by expert commercial and financial advisors, including the Water Industry Commission for Scotland. This analysis will be used to support advice on key aspects of the reform proposals, such as the number, size, and boundaries of new service delivery entities, and the entities' commercial and financial structures.

The rest of the reform programme is also progressing well

36. This is a large-scale, highly complex, 'transformational' reform programme. It involves exploring a number of difficult policy matters, designing new service delivery models and associated legislation, and developing the transitional arrangements needed to separate out a core function from 67 council providers, and merging these services into a much smaller number of new water entities. Treaty-related rights and interests are being considered and addressed throughout this process.
37. A substantial work programme and significant resources are required to continue developing and implementing the reforms. A number of workstreams have been established and are underway, covering: system design; entity design; economic regulation; iwi/Māori and Treaty-related considerations; transition arrangements; legislative design; communications and engagement; and supporting the Joint Steering Committee and associated reference groups.
38. This work needs to be informed by, and developed in the context of, the local government system, the Crown's Treaty partnership with iwi/Māori, and a range of community and stakeholder interests. Effective engagement and communications are essential if we are to understand all parties' perspectives.

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39. Initial engagement with the local government sector occurred in July/August 2020. Officials held a series of regional workshops with councils and iwi/Māori partners, supplemented by webinars and written material. These covered the high-level case for change, key design features of new water services entities, the MoU, and the process for accessing stimulus funding.
40. The Joint Steering Committee has also been meeting regularly over the past few months, to consider and provide input into the emerging policy options.
41. Discussions so far indicate there are likely to be three areas of particular interest for the local government sector. These relate to:
 - 41.1 the number and boundaries of the new entities (how big will they be?);
 - 41.2 retaining local 'voice' and influence, including regarding prioritisation of infrastructure to support growth, climate change adaptation, and ensuring water services entities are responsive to the needs and concerns of local communities;
 - 41.3 the impact of the reforms on councils, including immediate financial impacts, concerns about their ongoing sustainability and future role in the community, and concerns about the implications for staff.
42. These points are all being considered as part of the policy work programme, and will feature in future advice. They are also being considered in the wider context of the reforms to the resource management system, which are proceeding along a similar timeframe.
43. The third of these points – the impact of the reforms – is also part of a parallel conversation and piece of work with local government. It is worth noting that the likelihood of a voluntary approach to the three waters reforms succeeding may depend on central government support for this 'future of local government' work, and provision of a 9(2)(f)(iv) package.
44. More recently, officials have been conducting dedicated hui-ā-motu with iwi/Māori, in conjunction with Taumata Arowai. These sessions provided a useful indication of matters that are likely to be of particular relevance to iwi/Māori as Treaty partners, and to the Crown-Māori relationship going forward.
45. In acknowledging that the reform of water services is an important kaupapa, iwi/Māori expressed the view that resolving matters of ownership and allocation of freshwater are higher priorities to them. Some participants emphasised that, if the three waters reforms are to progress ahead of broader ownership and allocation claims, the reforms must, at the very least, not preclude any progress in these claims.
46. Other key themes from the hui-ā-motu included: cautious optimism about working together to design something that works better than the status quo for iwi/hapū and small rural communities; the need to ensure continued iwi/Māori involvement in all aspects of the reforms; ensuring strong protections against privatisation; not breaking catchments and whakapapa/iwi boundaries when designing the new entities; and a desire to see these changes utilised to build iwi/hapū skills and improve practices around water use and treatment.
47. A summary report on the hui-ā-motu is currently being prepared, and will be published on the Department of Internal Affairs' Three Waters webpage.

48. We will continue to engage with iwi/Māori throughout the reform process, and to deliver on our Treaty-related obligations. I am proposing that we commit to a high-level principle of partnership in this work, and seek to ensure this approach is reflected in the governance and operational arrangements of the new water service delivery entities and broader regulatory system.

The reform programme will need additional funding to continue to operate

49. Developing and implementing these reforms involves an extremely large and complex work programme, and a multi-year commitment. The scale of reform is similar to the local government reforms in 1989, electricity industry reform in the late 1980s, and the merger of 16 Institutes of Technology and Polytechnics into the New Zealand Institute of Skills and Technology. The resources involved should not be underestimated.
50. Significant progress has already been made in a short time with this work programme. However, the ability to continue to deliver the programme – and to do so at the necessary speed – is subject to funding.
51. As indicated in my June 2020 paper, substantial resources are required to progress the reforms. This work has only been partially funded in 2020/21, and is unfunded from 1 July 2021.
52. The Department of Internal Affairs (the Department) is facing significant funding pressures relating to the reform programme. The Department has been appropriated \$8.06 million in 2020/21 to progress this work, but is forecast to spend an additional \$7 million by 30 June 2021. The Department is unable to reprioritise such significant cost pressures within baseline funding.
53. Further cost pressures of approximately 9(2)(f)(iv) would be created in 2020/21 and 2021/22 in order to proceed with a public information and education campaign. This is an important component of the reform strategy outlined below, and is crucial if we continue to pursue the reforms in partnership with the local government sector.
54. The programme also needs to secure funding to operate after 30 June 2021. The next 18 months will involve an intensive period of work, which will be pivotal to delivery. The Department needs funding certainty now in order to plan and carry out the extensive number and range of activities involved in implementing reforms of this magnitude, and to retain essential personnel.
55. 9(2)(f)(iv)
56. I consider the operating contingency that was established for the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* provides a potential avenue for funding these cost pressures in 2020/21 and 2021/22 within the \$710 million already committed by Cabinet. A portion of this contingency (\$148.8 million) is currently unallocated and, with Cabinet's agreement, could be used for this purpose.
57. Further information on this matter is included in the Financial Implications section.

Before proceeding any further, we need to agree and provide direction on critical details of the reform strategy

58. In my June 2020 paper, I outlined a high-level approach to reforming three waters service delivery arrangements over a three-year period. However, many of the details involved in delivering this approach had not yet been fully developed or discussed. I am seeking to confirm these details now.
59. It is imperative that we continue to set an ambitious timeframe for this programme. As indicated in the diagram at **Appendix A**, I am proposing:
- 59.1 substantive policy decisions are made in April/May 2021, to enable drafting instructions to be issued – including decisions on the core design features of the new water services entities and system, and the number and boundaries of the new entities;
 - 59.2 legislation to create the new service delivery system is introduced in late 2021 and enacted by mid-2022 (prior to the local government elections); and
 - 59.3 transition, entity establishment, and implementation occur from 2022/23.
60. Before this programme can be progressed further, we need to consider and clarify critical aspects of our preferred reform strategy. Key considerations relate to:
- 60.1 proceeding with a voluntary approach – and the likely benefits, challenges and risks of this approach;
 - 60.2 the incentives that might be needed to support a voluntary approach;
 - 60.3 early legislative changes that are required to enable and support councils to consult their communities and make decisions on participation;
 - 60.4 how to ‘frame’ the decision councils would make, and associated processes and timeframes – including the potential roles for both central and local government in communications, engagement, and consultation;
 - 60.5 what councils would be participating in, and the information they would need to make these decisions;
 - 60.6 the approach to identifying and agreeing the number and boundaries of new entities;
 - 60.7 how to work with iwi/Māori – as our Treaty partners – throughout the reform programme, and ensure their rights and interests are reflected appropriately;
 - 60.8 the entity design options and key features that would be tested with credit rating agencies.

I am seeking to confirm details relating to a voluntary approach

61. The reform programme currently involves a voluntary, partnership-based approach with the local government sector. This was signalled through the Central-Local Government Forum in May 2020, and in my June 2020 Cabinet paper.
62. This approach has been given effect and further developed by central and local government representatives through the Joint Steering Committee. I am advised that this has been a highly constructive and productive arrangement, so far.

63. A voluntary approach has a number of benefits. Central government benefits from a 'willing partner' to develop and implement the reform proposals, and it is important the local government sector is supportive and collaborative. Councils own, and hold information about, most of the assets, and are mindful of the wellbeing of their communities. The Joint Steering Committee and sector reference groups provide valuable sources of political and technical expertise.
64. I note that a voluntary approach was used for the MoU in August 2020, and was highly effective, gaining buy-in from all eligible councils. A similar approach could be used next year, in relation to council decisions on whether to commit to new water services entities on an enduring basis.
65. The diagram at **Appendix A** provides further details about what a voluntary approach might look like in practice, within the context of Cabinet decision making, engagement with local government and iwi/Māori, and public communications.
66. We have a choice about whether or not to continue with a voluntary approach to reform. While this is my preference, it has a number of risks, challenges, and dependencies.
67. Key to achieving the Government's objectives for water services reform is unlocking the potential for significant economic efficiencies. Realisation of these efficiencies is necessary to ensure the investment required to 'catch up' on the historic infrastructure deficit is affordable for current and future generations of New Zealanders. Aggregation of water service delivery into a small number of large, multi-regional entities, together with clear policy objectives and an appropriate economic regulatory regime, is a key means by which these efficiencies can be achieved.
68. The scale of potential efficiency gains is significant, as demonstrated by similar reforms overseas. In New Zealand, the potential benefits are demonstrated through a recent (mock) draft determination of Watercare by the Water Industry Commission for Scotland (WICS), the economic regulator for Scotland.
69. This assessment concluded that, while Watercare is performing at a level that is unrivalled in New Zealand, it lags significantly behind the performance of the leading companies in the United Kingdom. WICS concluded there is significant scope for Watercare to reduce its operating costs by 4.4 per cent per annum over 10 years (that is, an improvement of more than 50 per cent in operating efficiency), while simultaneously improving its levels of service to customers. These estimated efficiency gains indicate the scale of benefits that might be potentially realised across the sector as a whole.
70. The success of the reforms in New Zealand is dependent on a significant majority of councils agreeing to be part of the new water services entities, and transferring their service delivery responsibilities and assets to these entities. Key factors include securing the participation of all metropolitan and large provincial councils, and arriving at a sufficiently small number of entities to achieve an effective economic regulatory regime.
71. With a voluntary approach, there is a risk that some councils choose not to participate, jeopardising the feasibility and effectiveness of the new system. If there is insufficient buy-in from councils – particularly the larger ones – this could mean there will not be the minimum 'threshold' needed to ensure the new entities are viable, and many of the benefits of the reform programme will be unrealisable.

72. In addition, it is likely that a voluntary approach is only achievable in conjunction with a number of other factors – including the use of 9(2)(f)(iv) incentives, public information campaigns, and early legislation. These factors are discussed further later in this paper.
73. I note that an alternative approach, in which council participation and asset transfer are mandated by legislation, also carries considerable risk. 9(2)(g)(i)
74. On balance, I consider that we should continue with a voluntary approach, and am seeking decisions to this effect 9(2)(f)(iv). However, we may need to reassess this position in the future, should it become clear that the reforms are at risk of not being achieved. I will work with the Joint Steering Committee and Three Waters Ministers to form a view on this judgement call, and include this in advice to Cabinet in April/May 2021.
75. To optimise the chances that a voluntary approach will be effective, councils and the public will need to have access to comprehensive, reliable information about the reforms. This will involve support from central government in two respects.
76. Firstly, it will be important that councils know what they are being asked to participate in, so they can consult appropriately with their communities, consider the financial and other implications of the proposals, and make informed decisions. Key pieces of information relate to:
- 76.1 entity design – including ownership, governance, control, and accountability arrangements;
 - 76.2 the consequences of transferring infrastructure, functions, staff, and service delivery to the new entities, including immediate financial impacts, and implications for the future financial sustainability of the council;
 - 76.3 financial arrangements – including balance sheets (pre and post reform), the terms of asset/liability transfers and other considerations, and stranded overheads;
 - 76.4 core system design features – including consumer protection mechanisms;
 - 76.5 the case for change – including the expected benefits of the reforms;
 - 76.6 which entity they would be part of, and its boundaries.
77. Under my proposed reform timetable at Appendix A, advice on all of these matters will be developed to inform policy decisions in April/May 2021. Central government would then prepare the detailed information listed above, and provide this to each council ahead of the decision-making window in late 2021.
78. Secondly, I am proposing to use a public information and education campaign to provide a national picture of the case for change, and to build wider support for the reforms. It will be critical for communities to understand the extent of the current infrastructure and funding challenges, and the opportunities this major transformational programme presents, as they engage with their councils on proposals. Funding will be required to support this comprehensive national campaign.

79. In addition, we need to consider how to frame the decisions that councils would be asked to make, to maximise the potential to achieve a successful outcome. I am proposing that this would be an 'opt out' decision, rather than the 'opt in' approach that was used for the MoU in August 2020.
80. Council participation would still be voluntary. However, the starting position would be that all councils would be included in one of the new entities, unless they choose to opt out. I consider that the case for change is likely to be sufficiently strong that councils and communities will recognise the benefits of continued participation.

If we proceed with a voluntary approach, we will need early legislation to enable and support councils to consult and make decisions

81. Although advice on the details of the new entities is still being developed, the in-principle decisions Cabinet made in June 2020 indicated our intention that these would be asset owning, statutory entities, structurally separate from local authorities.⁵ I anticipate these would be core features of any proposed new service delivery model.
82. Under the proposed reform strategy, councils will be asked to decide whether to make a commitment to participate in a new service delivery system. These decisions are likely to be sought in the last quarter of 2021.
83. As described further below, there are a number of provisions in the Local Government Act 2002 (LGA02) that create obstacles for councils in this respect. I am therefore proposing the Government introduces early legislation to deal with these obstacles, to enable and support councils' participation in the reform process.
84. Instructions would need to be issued to Parliamentary Counsel immediately, and a bill drafted for introduction in the first quarter of 2021, so any new arrangements are in place in advance of council decision making.
85. The first legislative obstacle is that provisions in the LGA02 oblige councils to maintain water services, and prohibit them from divesting ownership of these services, or from selling, transferring, or losing control of the infrastructure needed to provide the services (except to another council or council-controlled organisation).
86. These provisions need to be addressed to ensure councils are not barred from making a decision to participate in a new service delivery system that, on the passage of the substantive reform legislation, would result in the transfer of their water infrastructure and service delivery responsibilities to new water services entities.
87. The second legislative obstacle relates to statutory requirements around council consultation, long-term planning, and decision-making processes. This is a complex situation because an array of provisions, spread across local government legislation, would be 'triggered', due to the significance of a decision of this kind. The local government sector has asked for clarity about the process councils would follow in this respect.
88. These provisions would ordinarily mean, for example, that each council would be required to:

⁵ 'Structurally separate' refers to a water service entity operating, funding, and financing itself independently from its owner councils, so it can be rated by credit rating agencies on a standalone basis and raise debt in its own name.

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- 88.1 amend its long-term plan, after consulting on the proposed decision/amendments using the special consultative procedure, which would require it to;
- 88.1.1 issue a consultation document, containing information relating to the proposed decision, including an analysis of all the reasonably practicable options, and the likely consequences of proceeding with the proposal on rates, debt, and levels of service;
 - 88.1.2 have both the consultation document and amended long-term plan audited;
 - 88.1.3 provide people who are interested in the proposal with opportunities to present their views (with a minimum period of one month for doing so);
- 88.2 provide opportunities for Māori to contribute to the decision-making process;
- 88.3 give consideration to the views and preferences of interested and affected people during the decision-making process;
- 88.4 when making a decision, take account of the community's interests within its district, the interests of future as well as current communities, and the likely impact of any decision on social, economic, environmental, and cultural wellbeing.
89. These consultation and decision-making requirements are not fit for purpose in this particular context, and are unlikely to achieve a desirable outcome from either a local or central government perspective. For example:
- 89.1 Councils are concerned about the cost, resources, and time associated with preparing, consulting on, and auditing long-term plan amendments.
 - 89.2 There are risks that the Government's reform proposals and case for change are not presented accurately, consistently or comprehensively across the country, and that not all views are reflected – including the national interest.
 - 89.3 Requirements to identify, assess, and consult on all reasonably practicable options at an individual council level could mean there is a lack of focus on the Government's proposal, and the potential inclusion of options that do not align with our reform objectives.
 - 89.4 The consultation and decision-making requirements in the LGA02 do not include a role for central government in communications and engagement about the reforms, or reflect the Crown's obligations as a Treaty partner in relation to its role in these reforms.
 - 89.5 When making a decision, councils are expected to take account of community interests *within the district*. Some councils may consider that the multi-regional or national interest inherent in the reform proposals is outside their statutory mandate.
 - 89.6 Some interested parties – such as special interest groups and industry organisations that span across New Zealand – may find it difficult to participate in 67 separate council consultation processes. Iwi that cross district boundaries may also face challenges engaging with multiple councils simultaneously.

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90. My preferred approach is to use legislation to address these matters. In summary, this legislation would:
- 90.1 address the statutory obstacles in local government legislation that prohibit councils from divesting ownership of, or control over, water infrastructure assets and services – but only for the purposes of making a decision to participate in the Government's reform proposals to create new water service entities;
 - 90.2 remove or amend the detailed legislative requirements in local government legislation relating to council consultation, long-term planning, and decision making, for the purposes of making a decision to participate in the Government's reforms;
 - 90.3 provide a fit-for-purpose consultation process, based on the provisions in the LGA02, that sets out how local government would engage with communities and iwi/Māori about the reform proposals, and make decisions.
91. I am advised that initial conversations with the local government sector, including the Joint Steering Committee, have indicated there is support for this approach – providing decision making about whether to participate continues to sit with individual councils.
92. I understand the sector would welcome central government taking a leadership role in communicating the reform proposals, presenting the case for change, and supplying the detailed analysis councils will need to make decisions. I propose to continue to work closely with the Joint Steering Committee to develop and communicate the material to support consultation processes.
93. I am seeking agreement to issue drafting instructions and proceed with legislation in early 2021, with a view to achieving the following outcomes:
- 93.1 Councils are able to make decisions, in a timely manner, on whether to participate in Government-led reforms to water service delivery arrangements, which – on the passage of substantive reform legislation – would result in the transfer of their water infrastructure and service delivery responsibilities to new water services entities.
 - 93.2 Any legal impediments to councils consulting on and making these decisions are addressed.
 - 93.3 Councils have access to the information and support they need from central government, and there is a minimal burden on their resources.
 - 93.4 The New Zealand public is well informed of the details of the reform proposals, including the benefits and implications for each council or district, the objectives of the reforms, and the broader case for change.
 - 93.5 There is transparency throughout the reform process.
 - 93.6 There are roles for central and local government in communications and engagement, and the ability to work together where desirable.
 - 93.7 There are appropriate mechanisms for understanding the views and preferences of iwi/Māori, and to enable the Crown to fulfil its role under the Treaty of Waitangi.
 - 93.8 The risk of legal challenge is minimised.

94. I note that some of these outcomes may be achievable without prescription in legislation. This will be considered during the drafting process. As noted earlier in this paper, I have also indicated a preference for a centralised public information and education strategy, and have asked officials to prepare a nationwide communications strategy to socialise the benefits of reform with ratepayers and communities.
95. It will be important to ensure there is consistency with the existing local government legislative framework, including the emphasis on enabling democratic local decision making. Any new legislation would apply only in this specific context and would be time limited. There would be protections in place to ensure this legislation cannot be used to circumvent the usual obligations for councils to retain the ownership of their critical infrastructure and maintain service delivery.

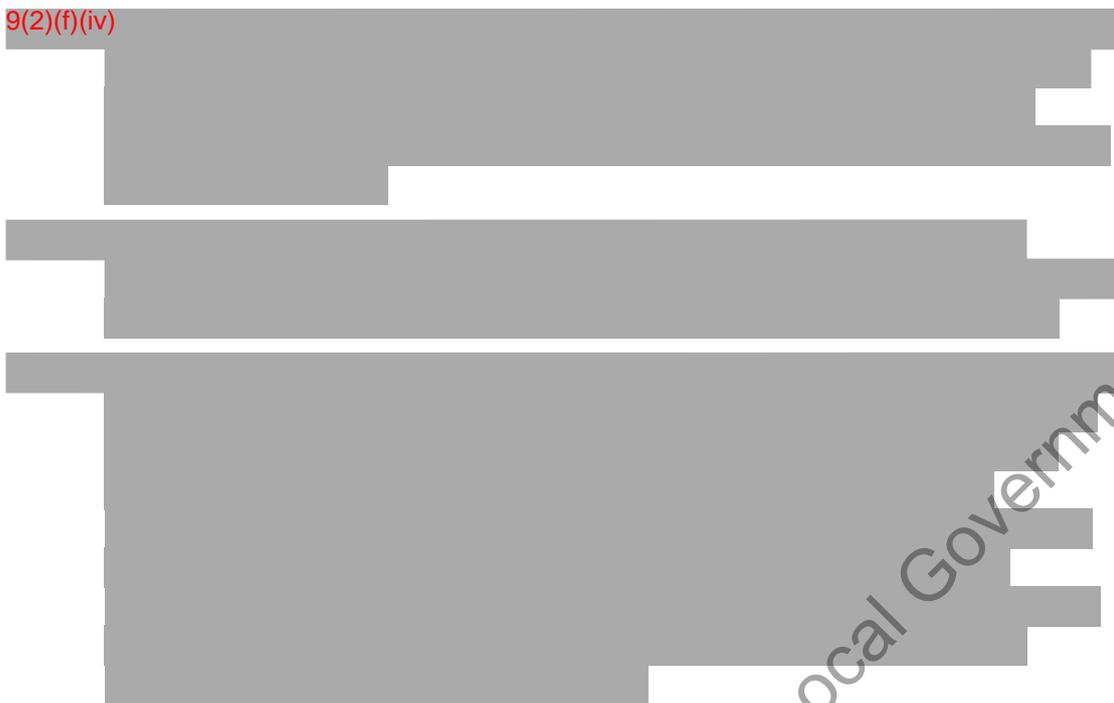
A voluntary approach is only likely to be successful if supported by an incentives package, and other factors to encourage participation

96. As noted earlier, funding from the \$710 million three waters stimulus package, announced in July 2020, was made available to councils that agreed to participate in the initial phase of the reform programme. This acted as an effective incentive, as all eligible councils chose to sign the MoU, initiating such participation.
97. The initial reform strategy outlined in June 2020 signalled the likely need for further tranches of investment later in the reform process, though no funding commitments were made beyond the first incentive package.
98. Early discussions with the local government sector have indicated that, if the Government proceeds with a voluntary approach to service delivery reform, this will need to be accompanied by a further package of incentives.
99. To be effective, it is likely that an incentives package will need to both:
 - 99.1 provide positive incentives that deliver immediate benefits for councils that agree to transfer responsibility for water service delivery to new water services entities; and
 - 99.2 make it clear that the future regulatory operating environment for three waters providers (including new water services entities, and any councils that choose not to participate in the reforms) will involve stronger enforcement of existing standards, and the potential introduction of new obligations and compliance requirements that add further costs.

9(2)(f)(iv)

[Redacted content]

9(2)(f)(iv)



103. There are also potential **non-financial and regulatory measures**, which could affect councils' willingness to participate in the reforms.
104. The most significant measure would be **provision of a clear role and future for local government after the three waters reforms**. Having a well-articulated future pathway would help to address councils' concerns about the impact of the reforms on their role in the community and ongoing sustainability.
105. Other measures relate primarily to improved transparency, and increased oversight in the regulatory system - in addition to the more stringent regulatory requirements that will apply to all three waters providers (including the new water services entities) over the next few years.
106. One potential measure is **increased requirements for disclosure of asset condition, service performance and cost of delivery**. Some of the current problems with water services, including persistent under-investment in infrastructure, poor network performance, inconsistent levels of service, and higher than necessary costs of delivery, are at least in part a function of a lack of transparency, oversight, and public accountability. The underground nature and long life-span of the infrastructure means these assets get less attention and priority than above ground community infrastructure.
107. As discussed later in this paper, it is anticipated that economic regulation would be an integral part of the service delivery system. This would ensure there is accountability, oversight, and transparency relating to the performance of the new water services entities. The entities (like all drinking water providers) would also be subject to monitoring by Taumata Arowai.
108. We could also consider introducing information disclosure requirements for a small number of councils that choose not to participate in the new entities, and continue providing water services directly. This would provide greater transparency about asset condition, levels of service, network performance, and the costs of delivery, and could be independently verified by an economic regulator.

109. There would be administrative and compliance costs associated with an information disclosure regime, which would be ultimately borne by consumers. Care would need to be taken during the design of any new regime to ensure the costs do not outweigh the benefits of increased transparency.
110. This approach may strengthen incentives on council suppliers to demonstrate they are maintaining and investing in their assets, and delivering water services in compliance with applicable regulatory standards. It would enable performance (including cost of service delivery) to be benchmarked against other suppliers.
111. Another potential measure relates to the development and implementation of **national performance standards for wastewater**, including improvements to consenting and monitoring of wastewater networks and regulation of discharges.
112. A number of wastewater plants and networks are currently operating on expired (or soon-to-be expired) consents, which are a cause of significant environmental issues. An extensive infrastructure upgrade programme is required, and will need to be paid for.
113. The proposed service delivery reforms provide a mechanism to address this situation. The increased scale of multi-regional water services entities also creates an opportunity to take a more strategic, catchment-based approach. For example, this could include upgrading networks and plants based on greatest environmental and cultural impact on water catchments, rather than upgrading individual plants on the basis of resource consent timeframes.
114. Councils that choose not to join the new water services entities would face increased performance standards and stronger regulatory enforcement of consenting requirements, which they would need to address alone. For some communities, this will likely lead to significant affordability challenges associated with the need to upgrade or replace their existing wastewater plants and networks.
115. Finally, the **implications of our drinking water regulatory reforms** will start to take effect soon. Taumata Arowai, and the Water Services Bill (if enacted), will mean there will be more emphasis on compliance with drinking water regulatory requirements, and greater transparency about the environmental performance of wastewater and stormwater networks.
116. Councils are already starting to recognise that they will be facing significant scrutiny from Taumata Arowai and their communities. They will be under increasing pressure to comply with drinking water quality standards, and could face enforcement action if they fail to do so. The proposed changes to the resource management system, if implemented, would have additional implications; for example, by strengthening compliance with, and enforcement of, environmental standards, limits, and targets. This situation may encourage many councils to pass their responsibilities to new water services entities.

We need to confirm the process for identifying the numbers and boundaries of the new water services entities

117. My June 2020 paper reflected Three Waters Ministers' preferences for the creation of a small number of large-scale water service entities, which would be separate from local authorities. Cabinet agreed there would be further discussions with Ministers and local government about the exact number of entities, and their boundaries.

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118. Ultimately, the decision about the number and boundaries of any entities will relate to the benefits offered by scale, against relevant community of interest considerations. Significant work is underway to ensure the benefits of scale are clear, and community interests are understood beyond current administrative constructs.
119. There is currently a level of uncertainty about the process for identifying and agreeing the number and boundaries of the new water services entities. This is of significant interest to local government, the Joint Steering Committee, and iwi/Māori, and the lack of an agreed process is becoming problematic.
120. I am seeking decisions on the process that will be followed, so this can be signalled as early as possible. This would provide much-needed clarity, and minimise the risk that councils will spend unnecessary time and resources pursuing other (sub-optimal) approaches.
121. I am proposing a **centrally-led process**, which involves the following steps:
- 121.1 Cabinet makes decisions about the reform strategy in December 2020 (through this paper), and publicises the proposed process for identifying entity numbers and boundaries.
 - 121.2 Officials complete analysis relating to entity numbers and boundaries, and work with the Joint Steering Committee and Three Waters Ministers to identify and confirm a shortlist of options.
 - 121.3 There is engagement on these options with the local government sector and iwi/Māori in March 2021 (noting that this will not be a formal consultation process, and the final proposals may differ).
 - 121.4 Cabinet makes decisions on the number and boundaries of entities, and other reform proposals relating to the new service delivery system, in April/May 2021 – followed by the preparation of legislation to give effect to these decisions, and public communications.
 - 121.5 Councils are invited to make decisions about whether or not to participate in the new service delivery system, and are equipped with the knowledge about which entity they would be part of (that is, its size and boundaries) at that time. They would also receive details on other key aspects of the reform proposals, such as entity design and transition arrangements.
122. I am advised that some local government representatives have suggested using an alternative, sector-led, 'expressions of interest' approach, in which groups of councils propose the boundaries of the entity they would form. I consider this approach is unlikely to be successful, take considerably longer, and provide no certainty of outcome. It is unlikely councils could agree on this issue, in the absence of agreement of other aspects of the reforms.
123. Key concerns and risks associated with a council-led approach include:
- 123.1 it may not result in many or any expressions of interest being agreed and proposed by councils (for example, because councils cannot agree);

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- 123.2 expression of interest proposals might not contain all of the features that are important from a central government perspective – such as sufficient coverage and uptake to create viable, sustainable entities; metros to ‘anchor’ each entity; consideration of iwi boundaries and catchments; and being of sufficient scale to access debt markets, and attract high-quality governance and specialist staff;
 - 123.3 councils and communities would not know which entity they would be part of during consultation and decision making;
 - 123.4 delays to the reform programme timetable – given it is likely to take a significant amount of time for councils to assess the implications of the reform proposals, consult their communities on whether to participate, work out which councils to collaborate with, and then prepare an expression of interest for government consideration;
 - 123.5 fragmentation – with multiple, different operational and legislative systems running simultaneously;
 - 123.6 lack of realisable benefits due to insufficient entity scale;
 - 123.7 an inefficient use of councils’ time and resources;
 - 123.8 iwi/Māori views are not taken into account;
 - 123.9 a lack of compatibility with other central government reform programmes, such as the reforms to the resource management system.
124. In addition, the analysis so far indicates that there is likely to be a relatively narrow set of choices about the number of entities – if we want to set them up for success and meet the reform objectives. This is discussed further below.

The case for change analysis is pointing to a small number of water services entities

125. Over the past three years, we have been developing the case for reforming local government water service delivery arrangements. As noted above, Three Waters Ministers have generally expressed a preference for a small number of large-scale entities (as indicated in the scenarios appended to the June 2020 paper). The intent is to realise a suite of medium-to-long-term economic, public health, environmental, and other benefits associated with entity scale, a large population/customer base, and achieving balance sheet separation.
126. Since June 2020, my officials have continued to develop the evidence base to support future discussions and decisions, and to inform communications with local government, iwi/Māori, and the general public about the potential benefits of reform. This work has been undertaken with oversight from the Joint Steering Committee.
127. So far, the economic case for change makes a compelling argument for a small number of entities. However, this cannot be viewed in isolation, and there are other factors that will need to be considered – including relationships with other boundaries (including catchments and iwi boundaries); communities of interest; the viability of implementing economic regulation; and future price paths. This will also need to be considered in the context of the proposed resource management reforms, as these are developed, particularly the proposed new regional spatial strategies that will set long-term objectives for urban growth and land use.
128. Further analysis has been commissioned to inform future advice and decisions.

Decisions about the number of entities are connected with considerations about equity

129. The case for change analysis indicates there are currently large differences across the country in the cost, price, and quality of water service provision. There is also limited transparency and understanding about the relationship between these factors across New Zealand communities.
130. Concerns about these issues were expressed throughout our early discussions, and are reflected in the reform objective to “ensure all New Zealanders have equitable access to affordable three waters services”. However, the nature and extent of our ambitions in this respect, what this might mean in practice, and the trade-offs that may need to be made, have not yet been decided.
131. Delivering this objective raises questions about the scope of the reforms, and how they would be designed and implemented. This will be particularly relevant to:
- 131.1 considerations about the number and boundaries of new entities;
 - 131.2 entity design choices around funding and pricing arrangements, service levels, and coverage (including potential obligations on, or responsibilities for, water service entities to extend services to, or provide support for, supplies that are not currently operated by councils);
 - 131.3 considerations about how central government can ensure costs and acceptable service levels are efficient and affordable for all communities;
 - 131.4 the timeframe for transition, the period over which investment ‘catch up’ occurs, and how much assistance can be made available to ease the transition.
132. There are several dimensions we will need to consider, under two broad headings:
- 132.1 **Equity of pricing:** The considerations here relate to our tolerance for different prices for households across different entities, and within entities; the extent to which we want to ‘smooth’ prices over time, or ‘harmonise’ prices across different customer groups; and affordability issues facing some groups. There are trade-offs between harmonisation and the achievement of efficient price signals, including ensuring prices create incentives for consumers to conserve water in areas or periods of constrained supply.
 - 132.2 **Equity of access to services, and service quality:** This includes the extent to which we will tolerate differences in service coverage, and levels of service; and whether or not the new entities would provide services to households and communities that do not currently receive water services from their local council. There is an interplay with pricing and charging, including considering how new connections would be funded.
133. We will have choices about how to address these issues, and may need to refine our objectives. Regarding pricing and charging, one approach would be to place constraints on the new water service entities. This would require careful consideration, though, as it could have unintended consequences. An alternative option could be to deal with affordability concerns outside of the entity, through central government payments designed to support vulnerable customers.
134. I will be seeking to have further discussions with Three Waters Ministers about these matters early next year, when more data and analysis become available.

There are other matters that require early direction if we are to keep on track with the reform timetable

Entity design scenarios need to be tested with credit rating agencies

135. In the June 2020 Cabinet paper, there was an ‘in principle agreement’ that new water services entities – if established – would be asset-owning, and have separation from local government to ensure the ability to borrow on similar terms to other utilities. The paper also acknowledged that independent, competency-based governance of water services entities is critical to achieve the governance and organisational capability improvements that will be required to realise the benefits from reform.
136. Achieving balance sheet separation and appropriate credit worthiness are crucial for ensuring the entities’ long-term financial sustainability, and embedding the ability to fund current and future investment needs. There are some key entity design considerations that will influence our ability to achieve these outcomes; for example: ownership; governance and control arrangements; and the number and boundaries of entities.
137. We need to provide some direction to officials now, so they can progress more detailed analysis, and provide advice on entity design features that meet our objectives of independent and quality governance, and financial autonomy to undertake infrastructure deficit investment.⁶
138. It is important to know, ahead of final entity design choices in April/May 2021, how a proposed structure may affect the balance sheet of local authorities, or the credit worthiness of the entity itself. Officials would, therefore, like to undertake a formal Ratings Engagement Service (RES)⁷ with Standard and Poor’s (S&P) in early 2021. Officials will test potential entity structures, within the ‘landing zones’ outlined below, and whether we can achieve a favourable rating outcome while meeting wider reform objectives.
139. These indicative ‘landing zones’ relate to three key entity design areas that S&P will be particularly interested in: the **governance arrangements**; the **objectives** of water services entities; and the **ownership structure**. Direction in these areas will enable officials to test, with more certainty, whether we will achieve a favourable rating treatment for the proposed entities, while also meeting wider reform objectives, ahead of seeking final policy decisions in April/May 2021.

Landing zone one: governance and autonomy requirements

140. In order to achieve balance sheet separation and independence consistent with reform objectives, councils will have less influence over water services entities than currently exists – particularly in areas of governance, and operational and financial decision making.
141. I expect councils to have a role in influencing:
- 141.1 the **strategic direction** of water services entities (for example, through a letter of expectations or similar mechanism);

⁶ A full suite of options will be canvassed and assessed as part of the regulatory impact analysis in May 2021.

⁷ A RES is an analytical assessment from S&P that provides guidance on the creditworthiness and balance sheet treatment of an initiative, such as the establishment of water services entities.

- 141.2 the **board appointments process** for water services entities (with the ability to influence removal of directors); and
- 141.3 **strategic planning decisions** (particularly as they relate to growth infrastructure), most likely through existing planning and regulatory mechanisms relating to land-use planning.
142. Officials intend to test a spectrum of options with S&P, which vary the influence that councils could have over water services entities, to understand what level of independence is required while also delivering balance sheet separation.
143. The current expectation is that both iwi/Māori and Crown will have influence over water services entities, alongside local authorities. Officials are considering options, and further engagement with iwi/Māori and Ministers is required to determine the form this should take.
144. The water services entities will need **operational and financial independence from local authorities**⁸ to achieve balance sheet separation. This is critical for the entities to have the balance sheet capacity and appropriate credit worthiness to meet current and future investment needs. Agreeing this base requirement will help to facilitate an efficient RES process.
145. Providing water services entities with financial independence, and limited local authority oversight, will require consumer protection and accountability mechanisms. Officials are still developing appropriate mechanisms but, at a minimum, I expect these to include:
- 145.1 **economic regulation** to protect consumer interests and to act as a driver of efficiency gains over time;
- 145.2 **consultation requirements** on the water services entity when developing its statement of corporate intent, investment plans, and proposed prices (tariffs);
- 145.3 **mechanisms that enable communities and consumers to participate** in water services entities' decision-making processes, which could provide checks and balances at several levels; and
- 145.4 **protections for vulnerable consumers**, such as requirements on water services entities to provide continuity of service.

Landing zone two: potential purpose and objectives

146. Water services entities will likely have their purpose and primary objectives expressed in legislation, which will serve as both a guide and a constraint on the function and operation of the entities.
147. The **purpose** of a water services entity is expected to relate to the provision of water services. To help achieve balance sheet separation, the water services entities need to have an express commercial objective – among other, non-commercial objectives.
148. Officials are seeking confirmation of our intended direction, at a high level; specifically, that the primary objectives will be targeted at the following key aspects:

⁸ Financial independence means the water services entities will have responsibility for determining an appropriate financial structure, making appropriate investments in the water network, and setting appropriate pricing to raise revenue. Influence from local authorities in these decisions, from the perspective of rating agencies, creates moral recourse that would not result in balance sheet separation.

- 148.1 a **commercial objective**; for example, “to operate as a successful business” or “to operate on an economic and commercial basis”;
- 148.2 **objectives reflecting the interests of key stakeholders and iwi/Māori**; for example, “give effect to Te Mana o te Wai”; and
- 148.3 **objectives that address fundamental sector issues**; for example, “operate in accordance with best practice asset management”.⁹

Landing zone three: potential ownership structure

- 149. Officials would like to test with S&P and stakeholders two main ownership options that are consistent with Cabinet’s June 2020 positions:
 - 149.1 a **collective (non-share based) ownership model**, where assets are owned by water services entities on behalf of the relevant local authorities; and
 - 149.2 a **share-based ownership model**, where assets are owned by water services entities, and relevant local authorities hold shares in the entities. Shareholding would reflect relative governance rights, rather than asset values.
- 150. How best to give effect to the two ownership models is still being explored. It is anticipated that new legislation will be required to establish the entities and/or the framework in which they operate. Bespoke forms of statutory entities are among the models being considered.
- 151. An ownership model, where shareholding is based on water asset values (or a similar proxy), is unfavourable given:
 - 151.1 issues associated with determining asset value (both upfront and over time);
 - 151.2 expected impact on balance sheet separation if this results in a large single shareholding; and
 - 151.3 limited value in any shareholding, especially if no dividends are paid and there are legislative restrictions on the sale of shares to ensure continued public ownership of water services entities.
- 152. Officials’ current thinking is that entities would not pay dividends, but would be able to make a surplus that could be reinvested in the business, helping to meet the costs of investment required to close the infrastructure deficit. A ‘no dividend’ policy would help protect against future privatisation, provide for a more favourable financial and pricing structure, and facilitate a less complex regulatory environment.
- 153. In the absence of dividends, the ability for water services entities to generate a surplus will be important for the effective operation of economic regulation. Final decisions on entities’ financial objectives, including any restrictions on dividends, will be sought in April/May 2021.

Economic regulation will be an integral part of the new system

- 154. Like other network utility sectors, three waters networks have strong natural monopoly characteristics that can lead to a lack of investment and innovation, and inefficient and/or poor-quality services being delivered to end consumers.

⁹ These objectives are subject to further advice.

155. Evidence from overseas jurisdictions and other utility sectors in New Zealand (such as electricity, telecommunications, gas and airports) is clear that economic regulation will play a critical part in a well-functioning three waters system. It will do this by protecting and enhancing the long-term interests of consumers, and providing system-wide performance information that will be utilised by a range of system players and stakeholders.
156. In particular, economic regulation drives:
- 156.1 efficient pricing, procurement and asset management practices;
 - 156.2 incentives to invest and innovate; and
 - 156.3 the provision of services at a quality and level of resilience that reflects consumer and wider community demands.
157. Effective economic regulation will support and reinforce good governance (another essential component of the reforms), by shining a light on the relative performance of water services entities, and strengthening the reputational incentives on boards to deliver services that meet consumer demands. In turn, economic regulation will need to be supported by high-quality governance arrangements, and a strong and enduring consumer and community voice throughout the three waters system.
158. Furthermore, economic regulation will support the drinking water regulation functions of Taumata Arowai, and the environmental regulation functions of regional councils, through its strong focus on asset management and the provision of high-quality performance information.
159. To function effectively, local and international evidence suggests that economic regulators need to be independent, credible, accountable, appropriately funded, and have an unrelenting focus on delivering the best possible outcomes for consumers.
160. Economic regulation regimes typically employ some combination of information disclosure that allows the performance of entities to be easily compared, engagement and negotiation between suppliers and consumers, and regulatory controls on the price and quality of services delivered to consumers.
161. There are administration and compliance costs involved in economic regulation regimes. The precise approach chosen needs to reflect the sector structure, institutional settings, and particular issues being faced by the sector. There are two main approaches:
- 161.1 **Information disclosure** is the lowest cost and least intrusive form of economic regulation, but it relies on reputational impacts from comparative benchmarking to drive performance.
 - 161.2 **Price-quality regulation** provides a stronger degree of regulatory control, to drive better outcomes for consumers, but requires a more individualised approach that is more expensive to administer.
162. In general, the smaller the number of entities in a given sector, the more efficient and effective the economic regulation will be. For example, a sector of one-to-five entities would allow greater economic regulation oversight through the use of individualised price-quality regulation, similar to that applied to the national grid operator, Transpower.

163. Responsibilities relating to economic regulation fall within the portfolio of the Minister of Commerce and Consumer Affairs. I anticipate we will work together – in discussion with other Three Waters Ministers – to identify an appropriate approach to regulating water services entities.
164. Taking into account all of the above factors, our initial view is that:
- 164.1 an efficient and effective economic regulation regime has a critical role to play in delivering on the objectives of the Government's three waters reform programme;
 - 164.2 at a minimum, an **information disclosure** regime that allows the performance of water services entities to be easily compared should apply to a substantively reformed three waters sector;
 - 164.3 **price-quality regulation** is desirable to drive efficiency and better outcomes for consumers, but has significantly higher administrative and compliance costs. Whether or not it will deliver net benefits or net costs to consumers will depend on the final industry structure and the governance arrangements of the proposed new water services entities.
165. Further information on the options for economic regulation, and the costs associated with different options, will be provided when Cabinet is asked to make substantive decisions on this matter. We note, though, that an industry levy is typically used to meet the costs of economic regulation.

Implementation

166. The June 2020 paper, *Investing in water infrastructure to accelerate reform and support economic recovery post COVID-19*, outlined an initial, high-level approach to implementing a three waters service delivery reform programme.
167. This paper seeks to refine, clarify, and/or confirm many of the essential components that are involved in implementing the reform programme. In particular, it seeks agreement to the key components of the overall reform strategy and timeline, and to the programme funding needed to deliver this strategy and achieve the proposed milestones.
168. As indicated in the diagram at Appendix A, key milestones and deliverables include:
- 168.1 further engagement with the local government sector and iwi/Māori in March 2021;
 - 168.2 substantive policy decisions in April/May 2021;
 - 168.3 a national public information and education campaign running throughout 2021;
 - 168.4 legislation to create the new service delivery system and entities being introduced in late 2021 and enacted by mid-2022;
 - 168.5 councils being asked to decide to participate in the new system and entities in late 2021;
 - 168.6 transition, entity establishment, and system implementation arrangements being designed during 2021 and starting to come into effect from 2022.

169. This is an ambitious timeframe and work programme, which will be challenging to deliver. The Programme Board referred to in the background section of this paper has oversight of the risks associated with this work, and how these risks are being managed.
170. Programme funding and resourcing issues are discussed in the section below.

Financial implications

171. As indicated in the June 2020 paper, substantial resources are required to progress the reforms. This work has only been partially funded.
172. On 6 July 2020, Cabinet agreed that up to \$710 million be available for the three waters service delivery reform programme, including:
- 172.1 an investment package of up to \$701.940 million to support local government to maintain planned investment and asset quality; and to support large-scale asset replacements and the bringing forward of “no regrets” investment in the latter part of the reform programme; and
- 172.2 up to \$8.060 million in departmental funding to meet the costs associated with the initial implementation of the three waters reform programme [CAB-20-MIN-0328.13 refers].

Addressing current cost pressures and future funding needs

173. The funding was set aside in the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* operating contingency. This contingency expires on 1 March 2021 and is indicatively phased in 2020/21. The Ministers of/for Finance, Local Government, Internal Affairs, and Infrastructure are jointly authorised to draw down funding from this contingency.
174. To date, \$269.634 million of the above-mentioned contingency has been drawdown: \$8.060 million in departmental funding, and \$261.574 million for the first 50 per cent instalment of the funding stimulus to eligible councils.
175. The second 50 per cent of the stimulus package to councils, of \$261.574 million, is expected to be drawn down in December 2020, and a further \$30 million of the contingency has been allocated for rural drinking water supplies. The remaining \$148.800 million is currently unallocated.
176. The Department of Internal Affairs (the Department) is facing significant funding pressures relating to the reform programme. The Department has been appropriated \$8.06 million in 2020/21 to progress this work, and is forecasting to spend an additional \$7 million by 30 June 2021. The programme is only funded until 30 June 2021. The Department is unable to fund such significant cost pressures within existing baselines.
177. The reform programme’s cost pressures in 2020/21 are driven by:
- 177.1 additional policy, commercial and legal advisory support, including specialist economic and independent regulatory expertise to develop the evidence base to support reform proposals (for example, the Water Industry Commission for Scotland);

- 177.2 substantial engagement activity, including the sector engagement workshops, hui-ā-motu, and further intensive sector and iwi/Māori engagement proposed for March 2021;
- 177.3 support for the Society of Local Government Managers and councils to engage with the reform programme, including significant support for the RFI process.

9(2)(f)(iv)

179. The public information and education campaign is an important component of the proposed reform strategy and is crucial if we continue to pursue the reforms in partnership with the local government sector. I propose to commence this campaign this financial year and allocate \$2 million towards it, taking the overall programme funding needs for 2020/21 to \$9 million.

9(2)(f)(iv)

181. I consider the currently unallocated contingency provides a potential avenue for funding the immediate cost pressures in 2020/21 (of \$9 million), 9(2)(f)(iv)

182. Specifically, I am seeking agreement to allocate the unallocated portion of the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* operating contingency as follows:

- 182.1 \$9 million to programme costs for the remainder of 2020/21 to address the current cost pressures and commence the public information campaign, to be drawn down immediately;
- 182.2 9(2)(f)(iv) departmental funding to support the continued delivery of the reform programme in 2021/22 and 2022/23, and to further progress the public information campaign, to be drawn down pending completion of a clear and robust forecast.

183. The table below shows the current and proposed allocation of the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* operating contingency.

Table 2: Allocation of the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* operating contingency

Purpose/application	\$ million
Stimulus package to councils - appropriated	261.574
Departmental programme costs - appropriated	8.060
Stimulus package to councils - agreed allocation	261.574

Rural drinking water suppliers' package -agreed allocation	30.000
Total allocated	561.208
Proposed allocation	
Departmental programme costs for 2020/21 (including public information campaign)	9.000
9(2)(f)(iv) [Redacted]	[Redacted]
[Redacted]	[Redacted]
Total Investment Package	710.000

9(2)(f)(iv) [Redacted]

[Redacted]

[Redacted]

Financial decisions sought in this paper

Extending the scope of the Three Waters Infrastructure Investment and Service Delivery Reform Programme operating contingency

- 186. The Treasury has advised that accessing the operating contingency for further departmental programme costs would require agreement by Cabinet. Therefore, I am seeking agreement to amend the decision made on 6 July 2020, which allocated \$701.940 million of the operating contingency to support local government to maintain planned investment and asset quality, and to support large scale asset replacement.
- 187. In particular, I am seeking to expand the scope of this contingency (in addition to the initial \$8.060 million) to include departmental programme costs, the public information and education campaign, and funding to enable councils to participate in the reforms and to address concerns about their future roles and sustainability. This aligns with the outcomes originally sought by Cabinet; that is, to support local government to maintain planned investment and asset quality, and support the reform programme.

Extending the expiry date of the Three Waters Infrastructure Investment and Service Delivery Reform Programme operating contingency

188. As agreed with councils in the Delivery Plans and Funding Agreements, any stimulus funding must be spent by 31 March 2022. Therefore, I am proposing to extend the expiry date of the operating contingency from 1 March 2021 to 1 March 2022, to better align with this timeframe.

Submitting actual and in-principle expense transfers

189. Finally, when Cabinet agreed the establishment of the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* operating contingency, it also agreed that any and all underspend related to the initiative would be returned to the COVID-19 Response and Recovery Fund, until it ceases to exist, and then to the centre [CAB-20-MIN-0328.13 refers].

190. There is inherent uncertainty around when councils will achieve the agreed milestones for the purpose of releasing the stimulus funding. There is also uncertainty on the timing of approval of the rural drinking water supplies' package and the overall timing of the departmental programme costs.

191. To manage this uncertainty, and ensure the funding is paid as per the planned amount, I am seeking agreement that any unspent funds in 2020/21, which result from the delay in councils delivering milestones in their Delivery Plans, or have been committed to by Joint Ministers for programme funding and rural drinking water supplies, are not considered underspends for the purposes of the decision in paragraph 8 of CAB-20-MIN-0328.13.

9(2)(f)(iv)

[Redacted content]

Legislative implications

196. I am seeking agreement to implement some of the proposals in this paper through a Local Government (Three Waters Reform) Amendment Bill, and approval to include this Bill on the 2021 Legislation Programme, with a priority category 2 (must be passed in the year).
197. Subject to this approval, I am intending to provide drafting instructions to the Parliamentary Counsel Office by 1 February 2021, in order that the Bill can be introduced no later than 1 April 2021, and passed no later than 1 November 2021.
198. As discussed earlier in this paper, if there is agreement to continue to take a voluntary approach to reform, councils would be asked to decide to commit to the new service delivery system in late 2021. Giving effect to a decision to participate would involve the enactment of substantive legislation establishing new water services entities in 2022, and transferring council water infrastructure and service delivery responsibilities to new entities in around 2023/24.
199. There are a number of provisions in the Local Government Act 2002 (LGA02) that create statutory obstacles for councils to make these decisions, or may make it difficult to achieve a desirable outcome from a local government and central government perspective. These include:
 - 199.1 provisions that oblige councils to maintain water services, and prohibit them from divesting ownership of these services, or from selling, transferring, or losing control of the infrastructure needed to provide water services;
 - 199.2 provisions relating to consultation, long-term planning, and decision making that would apply due to the significance of a decision of this kind.
200. The proposed Local Government (Three Waters Reform) Amendment Bill will, if agreed:
 - 200.1 address the statutory obstacles in local government legislation that prohibit councils from divesting ownership of, or control over, water infrastructure assets and services – but only for the purposes of making a decision to participate in the Government’s reform proposals to create new water service entities;
 - 200.2 remove or amend the detailed legislative requirements in local government legislation relating to council consultation, long-term planning, and decision making for the purposes of making a decision to participate in the Government’s reforms;
 - 200.3 provide a fit for purpose consultation process, based on the provisions in the LGA02, that sets out how local government would engage with communities about the reform proposals, and make decisions.
201. Subject to Cabinet approval, I may wish to seek input from technical experts from the local government sector and iwi/Māori during the drafting process.

202. I note that this proposed Bill will be the first of several pieces of legislation needed to implement a new three waters service delivery system and create new water services entities. I anticipate that policy decisions resulting in drafting instructions would be made in April/May 2021, and that Parliamentary Counsel Office would be asked to begin drafting the next Bill shortly afterwards. We may then need an additional Bill to give effect to further decisions relating to transitional arrangements to the new system.

Impact analysis

Regulatory Impact Statement

203. "The Regulatory Quality Team at the Treasury has determined that the legislative proposals in this paper, amending the Local Government Act 2002 to remove statutory obstacles for councils making decisions on the three waters reforms, are exempt from the requirement to provide a Regulatory Impact Statement on the basis that they have no or minor impacts on businesses, individuals, or not for profit entities. Detailed impact analysis will still be undertaken to inform final policy decisions by Cabinet on the three waters reforms."

Climate Implications of Policy Assessment

204. None.

Population implications

205. None.

Human Rights

206. None.

Consultation

207. The Ministry for the Environment; Ministry of Health; Ministry of Business, Innovation and Employment; The Treasury; New Zealand Transport Agency; Ministry for Primary Industries; National Emergency Management Agency; Ministry of Housing and Urban Development; Department of the Prime Minister and Cabinet; Kāinga Ora; Ministry of Transport; Te Puni Kōkiri; and Te Arawhiti have been consulted on this paper.

208. 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 in this capacity.

209. The Department of Corrections and Department of Conservation have noted that they are experiencing many of the issues identified in this paper, and are facing similar infrastructure investment deficits and funding requirements as local government. They would like to explore the opportunities that may become available with the creation of new water services entities. Officials will discuss this further as the reform programme develops.

Communications

210. A plan for communicating the decisions in this paper is being prepared. This forms part of a broader communications strategy relating to the reform programme, including the potential for a public information and education campaign signalled in this paper.

Proactive Release

211. I intend to publish this paper, subject to any redactions, pursuant to Cabinet Office circular CO (18) 4.

Recommendations

212. The Minister of Local Government recommends that the Cabinet Business Committee:

Context and progress update

1. **note** that New Zealand's three waters system is facing a number of significant challenges, and will continue to do so without major, transformational reform of service delivery arrangements;
2. **note** that in July 2020, the Government announced a \$710 million funding package to support economic recovery relating to COVID-19, and to address persistent issues facing the three waters sector, through a combination of infrastructure investment stimulus and service delivery reform;
3. **note** that since then a comprehensive service delivery reform programme (reform programme) has been established by the Department of Internal Affairs, which is progressing well, including:
 - 3.1 rolling out stimulus funding of \$523 million, in instalments, to every eligible council;
 - 3.2 developing and implementing a large-scale, multi-faceted work programme;
 - 3.3 setting up and supporting a Joint Central/Local Government Three Waters Steering Committee (Joint Steering Committee); and
 - 3.4 engaging and communicating with local government and iwi/Māori through a series of initial workshops, hui-ā-motu, and webinars;
4. **note** that there will be continued engagement with iwi/Māori throughout the reform programme, including to ensure the Crown delivers on its obligations relating to the Treaty of Waitangi;
5. **agree** that a high-level principle of partnership with iwi/Māori will be followed throughout the reform programme, and reflected in the new three waters service delivery system;

Confirming critical details of the future reform strategy and timetable

6. **note** that the June 2020 paper, *Investing in water infrastructure to accelerate reform and support economic recovery post COVID-19* [DEV-20-SUB-0079], outlined a high-level approach to reforming three waters service delivery arrangements over a three-year period, but many of the details involved in delivering this approach had not been fully developed at that time;

7. **note** that it is imperative to set an ambitious timeframe for this reform programme, and to confirm critical details of the preferred reform strategy and timetable, to enable it to continue at pace;
8. **agree** that the reform timetable includes the following key milestones:
- 8.1 substantive policy decisions relating to the reforms in April/May 2021, to enable drafting instructions to be issued, including decisions on:
 - 8.1.1 the core design features of the new water services entities and system;
 - 8.1.2 the number and boundaries of the new water services entities;
 - 8.2 introduction of legislation to create the new service delivery system in late 2021, and enactment by mid-2022;
 - 8.3 transition, entity establishment, and implementation of the new service delivery system from 2022/23;
9. **note** that the reform programme currently involves a voluntary, partnership-based approach with the local government sector, and that:
- 9.1 continuing with a voluntary approach has a number of benefits, as well as some risks and challenges;
 - 9.2 an alternative approach, in which council participation in the reforms and asset transfer is mandated by legislation, also carries considerable risk;
 - 9.3 a voluntary approach is only likely to be achievable and effective in conjunction with a number of other factors, including the use of:
 - 9.3.1 a nationwide public information and education campaign;
 - 9.3.2 9(2)(f)(iv) incentives to encourage council participation in the reforms; and
 - 9.3.3 early legislation to enable councils to consult and make decisions on participation in the new service delivery system;
10. **agree,** 9(2)(f)(iv) to continue to take a voluntary approach to reform, in which:
- 10.1 councils would be asked to decide to participate in the new service delivery system in late 2021;
 - 10.2 this decision would be in the form of an 'opt out' approach, whereby all affected councils would be included in one of the new water service delivery entities by default, but can decide not to continue to participate;
 - 10.3 central government would provide councils with detailed proposals and a package of supporting information ahead of the decision-making window, including details on:
 - 10.3.1 entity design proposals, such as ownership, governance, control, and accountability arrangements;
 - 10.3.2 the financial and other implications of participating in the proposed new service delivery system, including any applicable 9(2)(f)(iv) incentives;
 - 10.3.3 which water services entity each council would be part of, and its boundaries;

11. **agree** that central government will use a nationwide public information and education campaign to provide a national picture of the case for change and build support for the reforms;
12. 9(2)(f)(iv) [REDACTED]

Confirming the process for identifying the number of new water services entities

13. **note** that the June 2020 paper [DEV-20-SUB-0079] reflected Ministerial preferences for the creation of a small number of large-scale water service entities, which would be separate from local authorities, pending further discussions with Ministers and local government about the exact number of entities and their boundaries;
14. **note** there is a need to confirm the process that will be used to identify the number of entities and their boundaries, so this process can be communicated to the local government sector and iwi/Māori;
15. **agree** to proceed with a centrally-led process for identifying the number of entities and their boundaries, in which:
 - 15.1 a shortlist of option is identified, based on analysis of key factors such as achieving scale benefits; communities of interest; and relationship with other boundaries, including catchments;
 - 15.2 there is engagement on this shortlist of options with the local government sector and iwi/Māori in March 2021;
 - 15.3 proposals for the final number and boundaries of entities, and which entity each council would be part of, are considered by Cabinet in April/May 2021, followed by the preparation of legislation to give effect to the decisions made;
16. **note** that the options referred to in recommendation 15 will be developed by the Minister of Local Government, in consultation with other Three Waters Ministers (these being the Ministers of/for Finance, Infrastructure, Housing, Commerce and Consumer Affairs, Environment, Rural Communities, Climate Change, Health, and Economic and Regional Development) and the Joint Steering Committee;
17. **note** that decisions about the number of entities will be connected to considerations about equity of pricing and equity of access to services, and there will be further discussions with Three Waters Ministers about these matters in early 2021, when more data and analysis become available;

Early direction on entity design scenarios to be tested with credit rating agencies

18. **note** that independent, competency-based governance of water services entities is critical to realising the benefits of reform, and that balance sheet separation from councils is needed to provide entities with the financial capacity to meet the infrastructure deficit and future investment needs;
19. **agree** that the proposed water services entities will have:
 - 19.1 financial and operational autonomy, including independent and competency-based governance arrangements;
 - 19.2 a commercial objective, among other objectives;

20. **note** that officials are continuing to explore collective council ownership options that meet the reform objectives, including statutory entities on a shareholding or non-shareholding ownership basis, consistent with directions in the June 2020 paper [DEV-20-SUB-0079];
21. **note** that officials will also consider options for Crown and iwi/Māori interests in the new water services entities;
22. **note** that local authorities may seek influence in areas of strategic direction, governance and strategic planning, and that officials will test various levers and levels of influence with credit rating agencies in early 2021;

Early direction regarding economic regulation

23. **note** that economic regulation plays a critical role in protecting consumer interests and providing high-quality performance information that supports other important players in the three waters system;
24. **agree**, in principle, that an economic regulation regime will be employed in a reformed New Zealand three waters sector;
25. **note** that, all else being equal, economic regulation will be able to provide greater and more effective oversight, the smaller the number of regulated water services entities;
26. **agree**, in principle, that an information disclosure regime that allows the performance of entities to be compared will apply, at a minimum, to a substantively reformed three waters sector;
27. **note** that whether or not stronger forms of economic regulation, such as price-quality regulation, should also be employed will depend on the number of reformed water services entities and their governance arrangements;

Financial implications associated with this paper

28. **note** that on 6 July 2020, as part of the COVID-19 Response and Recovery Fund July Package, Cabinet:
 - 28.1 agreed that up to \$710 million be available for the three waters reform programme, including:
 - 28.1.1 an investment package of up to \$701.940 million to support local government to maintain planned investment and asset quality, and support large-scale asset replacements and the bringing forward of “no regrets” investment in the latter part of the reform programme; and
 - 28.1.2 \$8.060 million in departmental funding to meet the costs associated with the initial implementation of the three waters reform programme;
 - 28.2 agreed to set aside an operating contingency of \$710 million for the three waters infrastructure investment and service delivery reform programme, indicatively phased in 2020/21 with corresponding funding charged against the COVID-19 Response and Recovery Fund;

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- 28.3 authorised the Minister of Finance, Minister of Local Government, Minister for Infrastructure, Minister of Internal Affairs, and any other relevant appropriation Ministers (Joint Ministers), to jointly draw down the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* contingency [CAB-20-MIN-0328.13 refers];
29. **note** that the reform programme is only partially funded and faces cost pressures of \$7 million in 2020/21, driven by additional policy, commercial and legal advisory support, substantial engagement activity, and support for the Society of Local Government Managers and councils to engage with the reform programme;
30. **note** that an investment of 9(2)(f)(iv) (\$2 million in 2020/21 9(2)(f)(iv) is required to undertake a public information and education campaign directed to provide a national picture of the case for change and to build wider community support for the reforms;
31. **note** that the reform programme is unfunded after 30 June 2021;
32. 9(2)(f)(iv)
33. **note** that \$148.8 million of the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* contingency is currently unallocated;
34. **agree** that a further 9(2)(f)(iv) of the unallocated portion of the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* operating contingency is allocated as follows:
- 34.1 \$9 million to programme costs for the remainder of 2020/21 to address the current cost pressures and commence the public information campaign;
- 34.2 9(2)(f)(iv) departmental funding to support the continued delivery of the reform programme in 2021/22 and 2022/23, and to further progress the public information and education campaign;
35. **agree** to extend the scope of the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* contingency, previously agreed by Cabinet [CAB-20-MIN-0328.13 refers], to include departmental programme costs, the public information and education campaign, and support for the local government sector to engage with the reform programme;
36. **rescind** the decision in paragraph 20 of CAB-20-MIN-0328.13, referred to in recommendation 28 above, to give effect to recommendation 34 above;
37. 9(2)(f)(iv)

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38. **agree** to extend the expiry date of the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* operating contingency from 1 March 2021 to 1 March 2022, to align with the timeframes agreed with councils through their Delivery Plans and Funding Agreements;
39. **agree** to draw down \$9 million from the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* operating contingency, to address the programme cost pressures described in recommendation 29 above, and to commence in 2020/21 the public information and education campaign referred to in recommendation 30 above;
40. **approve** the following change to appropriations to provide for the decision in recommendation 39 above, with corresponding impact on the operating balance and net Crown debt:

	\$million -increase/(decrease)				
	2020/21	2021/22	2022/23	2023/24	2024/25 & Outyears
Vote Internal Affairs					
Minister of Local Government					
Department Output Expense: Local Government Policy and Related Services (funded by revenue Crown)	9.000	-	-	-	-

41. **agree** that the proposed change to appropriations for 2020/21 above be included in the 2020/21 Supplementary Estimates and that in the interim the increases be met from Imprest Supply;
42. **agree** the expenses incurred under recommendation 40 above be charged against the *Three Waters Infrastructure Investment and Service Delivery Reform Programme* operating contingency established on 6 July 2020 [CAB-20-MIN-0328.13 refers];
43. **note** that there is inherent uncertainty around the timing of releasing the remaining stimulus funding to councils, as this is based on achieving agreed milestones, and there is uncertainty about the timing of approval of the rural drinking water supplies' package and the overall timing of the departmental programme costs;
44. **note** that on 6 July 2020, Cabinet agreed that any and all underspends related to the initiatives approved in COVID-19 Response and Recovery Fund (CRRF) July Package be returned to the CRRF, until it ceases to exist, at which point they be returned to the centre [CAB-20-MIN-0328.13 refers];
45. **agree** that any unspent funds in 2020/21, which result from the delay in councils delivering milestones in their Delivery Plans, or have been committed to by Joint Ministers for programme funding and rural drinking water supplies, are not considered underspends for the purposes of the decision in paragraph 8 of CAB-20-MIN-0328.13;

Legislative implications associated with this paper

46. **note** that, if there is agreement to continue to take a voluntary approach to reform, under recommendation 10 above:
- 46.1 councils would be asked to decide to participate in the new service delivery system in late 2021; and
 - 46.2 giving effect to a decision to participate would involve transferring council water infrastructure and service delivery responsibilities to new water service entities in around 2023/24;
47. **note** that there are a number of provisions in the Local Government Act 2002 (LGA02) that create statutory obstacles for councils to make these decisions, or may make it difficult to achieve a desirable outcome from a local government and central government perspective, including:
- 47.1 provisions that oblige councils to maintain water services, and prohibit them from divesting ownership of these services, or from selling, transferring, or losing control of the infrastructure needed to provide water services;
 - 47.2 provisions relating to consultation, long-term planning, and decision making that would apply due to the significance of a decision of this kind;
48. **note** that if a voluntary approach to reform is to work, these statutory obstacles will need to be addressed through legislative amendments to the LGA02;
49. **note** that the Local Government (Three Waters Reform) Amendment Bill will:
- 49.1 address the statutory obstacles in local government legislation that prohibit councils from divesting ownership of, or control over, water infrastructure assets and services – but only for the purposes of making a decision to participate in the Government’s reform proposals to create new water service entities;
 - 49.2 remove or amend the detailed legislative requirements in local government legislation relating to council consultation, long-term planning, and decision making for the purposes of making a decision to participate in the Government’s reforms;
 - 49.3 provide a fit-for-purpose consultation process, based on the provisions in the LGA02, which sets out how local government would engage with communities and iwi/Māori about the reform proposals, and make decisions;
50. **approve** the inclusion of a Local Government (Three Waters Reform) Amendment Bill, on the 2021 Legislation Programme, with a priority category 2 (must be passed in the year);
51. **invite** the Minister of Local Government to issue drafting instructions to Parliamentary Counsel Office, in accordance with the decisions in this paper;
52. **note** that drafting instructions will be provided to the Parliamentary Counsel Office by 1 February 2021;
53. **note** that the Local Government (Three Waters Reform) Amendment Bill should be introduced no later than 1 April 2021, and passed no later than 1 November 2021;

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54. **authorise** the Minister of Local Government to approve matters of detail consistent with policy that may arise during the course of drafting, including any consequential amendments to other legislation that may be required;
55. **agree** that technical experts from the local government sector and iwi/Māori can be consulted, if needed, during the drafting process.

Authorised for lodgement

Hon Nanaia Mahuta

Minister of Local Government

Proactively released by the Minister of Local Government

