

Economic Regulation and Consumer Protection for Three Waters Services

Submission to the Ministry of Business, Innovation and Employment

December 2021



What is Taituarā?

Taituarā — Local Government Professionals Aotearoa thanks the Ministry of Business, Innovation, and Employment (the Ministry) for the opportunity to submit regarding the discussion document Economic Regulation and Consumer Protection for the Three Waters Services.

Taituarā — Local Government Professionals Aotearoa (formerly the NZ Society of Local Government Managers) is an incorporated society of 942 members¹ drawn from local government Chief Executives, senior managers, and council staff with significant policy or operational responsibilities. We are an apolitical organisation. Our contribution lies in our wealth of knowledge of the local government sector and of the technical, practical, and managerial implications of legislation.

Our vision is:

Professional local government management, leading staff and enabling communities to shape their future.

Our primary role is to help local authorities perform their roles and responsibilities as effectively and efficiently as possible. We have an interest in all aspects of the management of local authorities from the provision of advice to elected members, to the planning and delivery of services, to the less glamorous but equally important supporting activities such as election management and the collection of rates.

The three waters reforms and economic regulation

For the last 18 months Taituarā has participated in the Three Waters Reform processor as a 'critical friend'. The sector has generally accepted the need for stronger enforcement of regulatory standards in health, and to a lesser extent accepted increasing environmental standards. The primary case for reforms is that the cost of meeting these standards over the next 30 years may be unaffordable for smaller to medium sized communities.

Reforms, of whatever shape, are likely to founder if there is any suggestion that water users are being 'overcharged' for their service, or that the funds raised are not being spent 'appropriately'. Overseas jurisdictions rely on a framework of economic regulation to exercise some control over price, quality, and investment. Typically, this regulation is based on requirements to disclose key information about charges, costs, and investments and some form of regulatory control over prices or revenues.

¹ As of 31 October 2021

Economic regulation is likely to play an important role in securing overall consumer confidence in any change proposals.

Currently New Zealand has no economic regulation of three waters services beyond general consumer law and the mandatory disclosures of expenditure and costs imposed under the Local Government Reporting and Prudence Regulations. The only other economic regulation we are aware of is a prohibition on Watercare distributing a surplus to its shareholding council, and a requirement for local authorities that contract out etc to retain control of pricing decisions.

Taituarā therefore acknowledges the need for economic and consumer protection regimes to support whatever reform is to proceed. However we do so with some reservations.

Three waters infrastructure is a network and has similar qualities to the telecommunications and energy networks the Ministry is familiar with. But there are some important differences. Three waters infrastructure is subject to a regime designed to promote a set of public health outcomes (administered by Taumata Arowai) and a mix of national and regionally set environmental standards.

With that, and the roles of the Ministry of Health and others there is the potential to replicate the fragmentation of responsibilities that was one of the less desirable aspects of the outgoing system. The list of those with stewardship and other responsibilities in Table 11 gives us real concern, especially when set against the present skill shortages in the policy and regulatory occupations. It is also suboptimal from the end user's perspective as it creates role confusion and the cost of lost time and effort trying to present a complaint etc to the 'wrong' agency. We will return to this throughout the submission.

The economic regulation framework

The case for regulation

Taituarā considers that the document has established a case for economic regulation of three waters services.

The document asserts, quite correctly, that the reform model has some incentives that will counteract some of the behaviours present in natural monopolies. In particular, WSE will be prohibited from distributing a surplus to owners. The model is one of public ownership (though of a different form than those local authorities are used to).

The conclusion the WSE will not be subject to normal capital market discipline was more of a surprise. There is an expectation that the WSEs will be borrowing at scale,

including the ability to access the Local Government Funding Agency and (we understand) borrow overseas, in foreign currency. This was supported by a policy decision that WSE would have balance sheet separation from their local authority owners. We consider sufficient capital market disciplines exist.

There is one factor that the document overlooks. The reform model has been developed under an assumption that the costs of meeting regulatory standards will be spread over each WSE area. In effect there is an assumption that there will be cross-subsidisation between customers of each WSE areas. In that case, transparency will be a particularly important part of the regime to establish that funds are being legitimately raised and used.

A second aspect of the reform model that the document overlooks is that (unlike energy or telecommunications) there will be very little ability to 'switch providers'. The competitive tension of a freely operating market will be absent. Economic regulation introduces an element of competitive tension, with the disclosure of information enabling the benchmarking of financial and non-financial performance.

We accept the points made about economic regulation and quality of service, although we qualify this by noting that Taumata Arowai will be responsible for determining quality standards. The level of expenditure required to meet these standards long-term (which has been calculated at \$120-180 billion by the Water Commission for Scotland) will create a demand for transparency beyond what an annual report might generate, and quite probably beyond the 2020 request for information.

Purpose of economic regulation

The document asks whether the generic regulatory regimes (such as the Commerce Act) should apply or whether a purpose built regime is required. Earlier in the submission we described the differing characteristics of three water infrastructure. These factors, and the reality that water is truly necessary to sustain life suggest that economic regulation should be purpose built – though it may draw on some of the principles from the regulation of other network infrastructure.

The document also asks a series of questions about a statement of purpose for any economic regulation. The proposal is that the statement of purpose be based on the Telecommunications Act i.e.

The purpose of this [regime] is to promote the long-term benefit of consumers in market [X] by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

- (a) *have incentives to innovate and to invest, including in replacement, upgraded, and new assets*
- (b) *have incentives to improve efficiency and provide services at a quality that reflects consumer demands*
- (c) *share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices and*
- (d) *are limited in their ability to extract excessive profits.*

This appears generally sound, although we have a few suggestion for refinement.

We are concerned that the above purpose clause does not have a specific recognition of long-term sustainability of services. This is critical to counteracting the understandable, but undesirable, tendency to short-termism, and promoting long-term management of the assets. Arguably sustainability of service might be captured by the phrase 'long-term benefit of consumers', though it should be clearer.

The purpose statement refers to service quality that reflects consumer demands. In many services that's appropriate. However three waters services are subject to a higher level of regulation of quality standards than consumers might set in a free market, especially safety and environmental standards. The purpose statement should be expanded to include regulatory requirements.

WSEs cannot distribute profits to their owners. That being the case, there is little incentive for these entities to price in a manner that would generate excess profits. We are not convinced that there is any need for the fourth 'bullet' in the above purpose statement.

The document raises the possibility of legislation setting secondary objectives for the regulation. We submit that if not in the purpose statement, the legislation should also clarify that economic regulation should support or promote compliance with health and environmental regulations. Given the nature of these services, consumers might also value some degree of predictability in sources and levels of funding.

WSE will be making decisions that impact on Te Mana o te Wai. An understanding of Te Tiriti and Te Ao Māori and their implications for, application to, three waters services is absolutely fundamental. The requirement should be included in the statutory skill sets for the governing body of the regulator.

The scope and coverage of economic regulation

Taituarā considers that the level of public interest will be highest in the pricing and spending policies of the four WSEs. They will serve the largest number of customers and are likely to manage all three of the services to transfer in 2024. In many cases

the WSEs will sit more remotely from the consumer than, say a community scheme. The nature of the reform process will also generate public interest. As large, capital-intensive entities even a small regulatory driven performance gain could have a significant financial impact.

Taituarā would not support the inclusion of self-suppliers within the regime for economic regulation. Most self-suppliers are just that and supply only themselves and maybe a very limited number of others (e.g. a sharemilkers residence on a farm). We assume that the supplier and customer in these cases will either be one and the same, or will be well known to each other.

Community schemes sit somewhere in the middle. Most are small and the suppliers are well-known to the users. The governance models are not complex. In most instances we doubt the costs and benefits of economic regulation would stack up. Indeed we suspect the additional compliance of reporting both against economic and health regulation might serve to encourage these schemes to fold into the WSEs.

So what networks should be subject to economic regulation?

The discussion document recommends that drinking water, wastewater and stormwater networks should be regulated, with a concession that the case for regulating stormwater is more 'finely balanced'. We think the case is a little less finely balanced than the document.

A service failure of stormwater has potentially disastrous economic, social, environmental and public health consequences.. Regulating stormwater is seen as critical to integrated management of the catchment. The public will look for as great a degree of assurance with these services as with drinking and stormwater.

Additionally we submit that in many cases stormwater is the class of assets where local authorities know the least about asset condition and performance and asset plans are a little less well developed. While we expect that some attention will be given to rectifying these matters as part of the due diligence and establishment processes between now and 1 July 2024. Regulation would provide a further impetus for improvement in this area. A higher level of risk and uncertainty will drive a greater call for explanation which disclosure will put the WSEs in a better position to answer.

The balancing that the discussion document refers to is a cost/benefit question. The document quite correctly notes that the exclusion of stormwater would create regulated and unregulated classes of assets. With that would come the cost in developing common methodologies for allocating common costs (though some aspect of this work would be necessary anyway). There will be a cost of including

stormwater assets in maintaining the base of information to support mandatory disclosure and preparing the disclosures (though with careful design the regime would support improved knowledge of assets). That in itself warrants a significant transitional period.

Set against this, we see the benefits on improving asset knowledge and a better public understanding of the cost and levels of service from these activities. It may be that the first of these is more short-term and might then trigger a review after say five years.

The form of economic regulation

The document discusses the two main categories of economic regulation: the so-called information disclosure regulation and the price-quality regulation. We concur that any economic regulation should draw on aspects of each – though we have some qualifications and concerns with each.

We regard an information disclosure regime as the ‘do minimum’ option for the reasons given above. But the framers of these regulations must be cognisant of the disclosure that is required under legislation and regulations, most notably reporting to Taumata Arowai, but also (potentially) disclosures under the Non-Financial Performance Measures regulations under the Local Government Act 2002. Duplication of other disclosures must be avoided.

A second critical aspect of the information disclosure regime is that the disclosures are intended to be public-facing. We accept a regulator will need relatively detailed information to perform their functions, but much of this may be technical. The information for public disclosure must be customer-centric.

Footnote 21 refers to the 2020 ‘request for information’ as an example of the information regulators might look for. While this comment was something of an *obiter dicta* meeting that information request was a significant undertaking even in some of the larger local authorities. If the regulator’s needs are that detailed then there will need to be significant lead time to allow for the development of systems/process to produce, methodologies for matters such as cost allocation, possibly standard funding policies, and desirably, common asset and financial systems .

In short, do not underestimate the complexity of what is often seen as the ‘low calorie’ form of regulation.

Price-quality regulation goes to one of more significant of the public concerns about the reform process, the impact on the wallet. The Government, the regulator, and

the WSEs face a challenge in managing public expectations. The scale of the necessary increase in revenues is going to be significant, even in a regulated environment.

The regulator will need to be well aligned with, and have a sound understanding of, the public health and environmental regulation frameworks developed by Taumata Arowai. It would be undesirable for regulations and enforcement designed to increase quality standards to come into conflict or be unsupported by unduly tight economic regulation. Rational judgements based on an understanding of the three waters sector, including asset needs and cost drivers will be required.

Transition and Implementation

Developing a robust regulatory regime involves assessing the information that's required, assessing the information, developing a proposal and engaging on that. Its a complex task to do well and in honesty we can't see this as being anything less than a 2-3 year project.

Bringing stormwater within the scope of economic regulation will add to the complexity of this task. We understand that no other jurisdiction has subjected stormwater to economic regulation. There will therefore be overseas experience to draw on – regulation would be truly created from scratch.

At the same time we are some distance from having a regulator in place – and a minimum of 9-12 months from even having legislation to empower development of a regulatory framework. We simply cannot see that the regulator could do a robust job in the available time between now and 1 July 2024.

Of necessity, reforms will need to be implemented gradually. Of course transition would have always been required. While the exact scale of additional funding required is a matter for some dispute in the sector, the need for a step change in the overall level of funding is not in dispute.

Three waters funding will also need to transition from 67 locally developed, and somewhat bespoke, funding arrangements to a much smaller set. One of the stated rationale for the reforms was to empower a degree of network pricing over large geographic areas to spread the costs of meeting regulatory standards. That will be needed from 'day one'.

We consider that the regulatory regime will need to be implemented gradually from 2024 to 2027. A transitional price path will be required to transition from one set of funding arrangements to another. That transitional path must commence the step

change in funding levels, the reforms will fail to deliver if the WSEs are unduly constrained from day one.

We would be concerned if the transitional path were developed through the Government Policy Statement. This should be a strategic document rather than a means for Ministers exerting operational control over the WSEs. Such a move may replace one set of political dynamics with another – especially as the development will be happening in an election year.

We therefore come back to the regulator setting the transitional paths (we say paths because we suspect it will be one path per WSE). But, mindful of the workload on the regulator, we recommend that this path be based on an analysis of the information in the RFI and as updated in the 2021-31 long-term plans. The regulator should also be required to seek external advice in developing the path. This could be Te Waihanga – the Infrastructure Commission, or one of the overseas regulators (such as the Water Commission for Scotland).

One last thought on transition, is that the legislation empowering the regulation should provide for a regular and independent peer review of the regulatory settings. Again this might be the Infrastructure Commission or one of the overseas regulators.

The document asks about the regulatory period. Five years does not seem much more than short-term for entities that are delivering network infrastructure. Cabinet's decisions to date suggest the WSEs have been asked to develop a 10 year funding and pricing plan, and a 10 year asset management plan. Taituarā has further recommended that the WSEs develop a thirty year infrastructure strategy. We submit that the regulatory period should be ten years at a minimum though it may be wise to provide for a review.

Pricing

Broadly speaking, the regulator should be applying many of the standard principles of infrastructure pricing specifically: financial sustainability (in the long-term), efficiency, transparency, and affordability. The regulator should be developing proposed regulations for engagement with the WSEs and consumers that give effect to these principles.

Consumer Protection Regulation

New Zealand has a well-established set of 'generic' consumer protection legislation in the Commerce Act, the Fair Trading Act and the Sale of Goods Act, backed up with an independent regulator in the Commerce Act. These currently apply to the

delivery of three waters services – though we understand there is not usually much consumer recourse to these authorities.

In addition to the above, Cabinet has already made some policy decisions that provide consumer protections over and above the 'generic' legislation. These decisions will be incorporated into the upcoming Water Services Entities Bill and include the following:

- the WSEs will be required to operate in an open and transparent manner including with relation to setting prices, to setting levels of service and reporting performance
- the WSEs will be required to partner and engage early and meaningfully with Māori, local communities and local government. As with the preceding requirement it appears Parliament intends these both be ingrained in the 'DNA' of the WSEs
- the obligations to engage extend to the Asset Plan and Funding and Pricing Plan, and include an obligation to explain how consumer feedback has been taken into account (an obligation that doesn't extend to the current providers!)
- there will be a mandatory consumer charter setting out standards of service.

In addition to those anticipated responsibilities, the Water Services Entities Act 2021 has established the following consumer protection features:

- Taumata Arowai may set standards for drinking water and some aspects of wastewater
- all suppliers must have a consumer complaints process – which will be monitored by Taumata Arowai and
- a consumer may ask Taumata Arowai to review the way a complaint has been managed. Taumata Arowai is empowered to investigate and make recommendations.

And, of course, the economic regulator will be setting economic regulations.

We're not certain what additional consumer protection would be required that has not already been provided for.



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