NEW ZEALAND
INFRASTRUCTURE
COMMISSION
Te Waihanga

Water Services Economic Efficiency and Consumer Protection Bill

Report to the Department of Internal Affairs

February 2023

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Purpose

This report summarises the analysis undertaken by Te Waihanga of the Water Services Economic Efficiency and Consumer Protection Bill.

The purpose of the report is to inform the next steps of water services policy and legislation development. Te Waihanga has looked at the Bill in terms of how it will facilitate the improved provision of water services and infrastructure and has focussed on some key points summarised below.

Summary

Te Waihanga NZ Infrastructure Commission welcomes the opportunity to provide feedback on the Water Services Economic Efficiency and Consumer Protection Bill (the Bill). We support economic regulation of the four monopoly water service providers and the consumer protection provisions in the Bill.

The timing of Commerce Commission oversight of major water investments is too late

The Bill contains provisions to speed up the introduction of information disclosure regulation, and it allows for bringing forward the start date for price-quality regulation for Entity A (the Northern water services provider), which could start as early as 1 Jan 2027. We endorse these provisions.

However, Commerce Commission oversight of major investments needs to be introduced more quickly for all water services providers. The timeframes in the Bill mean the other water services providers are likely to be operating for six years, necessarily making significant investment and pricing decisions, before coming under price-quality regulation.

In our view, the Bill should be amended to enable the Commerce Commission to have oversight of major water services provider investment decisions (eg, investments exceeding $20 million) from 1 July 2024, prior to formally adopting price-quality controls. A corresponding amendment to the Water Services Legislation Bill could be made to prohibit water services entities undertaking major investments that have not been approved by the Commerce Commission.

Although a fast-tracked approach for investment oversight would require additional funding for the regulator, water networks are a capital intensive activity. In our view, the additional funding is likely to be repaid many times over with better investment decisions, with flow-on benefits to consumers.

More clarity is needed about which Act takes primacy

We are concerned the charging provisions in Part 11 of the Water Services Legislation (WSL) Bill, which is the companion to this Bill, are far more prescriptive than necessary and we are recommending several should be deleted.

However, if the prescriptive charging provisions in the WSL Bill are retained, we are concerned about how they reconcile with the price regulation provisions in the EECP Bill. The EECP Bill states that the purpose of price and quality regulation is to promote outcomes consistent with those in competitive markets, however, several of the charging provisions in the WSL Bill appear to preclude pricing arrangements that one would expect to see in competitive markets.

The definition of 'consumer' needs to better capture unconnected parties

The WSL Bill allows water services entities to charge water levies on the owners of properties that are not connected to the water network. As they do not receive any services from the network, levy payers are not customers of the water service providers, nor are they consumers as usually defined in economic regulation.

The EECP Bill defines a *consumer* as a person who consumes or acquires water infrastructure services. We are concerned this definition is inadequate as the levies are imposed on unconnected parties and the parties do not receive a service in exchange for paying those levies. In that sense, it may be contested that unconnected parties acquire services from water services providers.

We suggest a straightforward solution, to remove all doubt, would be to replace "acquire" with "is liable to pay for" in the definition of consumer.

Cost efficiency incentives should be in the Bill

The Bill states that a price-quality path may include incentives for a regulated water services provider to maintain or improve its quality of supply. However, it does not mention incentives to improve cost efficiency, which is essential to improve affordability for consumers.

In our view, it is critical the Commerce Commission has the flexibility to adopt incentive schemes that encourage cost efficiency, just as it does for electricity lines businesses subject to economic regulation. This will be even more important for water services providers, as they have multi-layered governance arrangements, and they may average their prices geographically. Both features are likely to weaken their cost efficiency incentives and result in consumers facing higher prices than necessary.

Innovative incentive schemes may be needed as the water services providers are prohibited from distributing any surpluses to their shareholders, for example in the form of dividends. This is likely to require a period of trial and error, and a degree of tolerance from the regulated entities and from Ministers. We have made recommendations to this end.

Consequential amendments

As noted above, the charging provisions in Part 11 of the WSL Bill are far more prescriptive than necessary and we have suggested several should be deleted. However, if these provisions are retained, we have suggested amendments to enable greater flexibility. As some of those amendments involve the Commerce Commission, this report includes corresponding amendments to the Water Services Economic Efficiency and Consumer Protection Bill.

Schedule of recommendations

Recommendation 1: Amend clause 51 by inserting a new subclause stating "(2) The funding and pricing plans in subsection (1) may include–

(a) methodologies for adopting alternative liability arrangements for charges for water services; and

(b) a methodology documenting why and how it wishes to adopt alternative approaches to charging stormwater fees; and

(c) a methodology documenting why and how it plans to charge persons owning property not connected to the water services entity's water supply or wastewater network.

Recommendation 2: Amend clause 52 by inserting new subclauses (2) and (3) as follows: "(2) If the Commission considers that–

(a) Any independent assessment provided to the Commission under section 51(2) does not suitably consider all arguments, facts and evidence or does not make reasonable conclusions based on that analysis, the Commission may direct the board of a regulated water services provider to not adopt the methodology.

(b) Any methodology provided to the Commission under section 51(2) materially inhibits, or is likely to materially inhibit, the effectiveness of the Commission's regulation of the water services provider, the Commission may direct the board of a regulated water services provider to not adopt the methodology.

(3) For the avoidance of doubt–

(a) Section 52(a) requires the Commission to form a view about whether the independent assessment meets the standards reasonably expected of that type of analysis, having regard for the facts and evidence reasonably available to the independent assessor; and

(b) If the Commission affirms an independent assessment–

(i) the Commission is not implying the independent assessment reflects the quality of analysis the Commission would have achieved; and

(ii) the Commission is accepting the conclusions in the independent assessment are ones reasonably open to the assessor, and the Commission may have made different conclusions had it undertaken the assessment."

Recommendation 3: The Bill be amended to make it clear that targeted incentives, including time-of-use charging and scarcity pricing, are permissible.

Recommendation 4: Amend clause 7 by replacing "acquire" with "is liable to pay for" in part (a) of the definition of consumer.

Recommendation 5: Amend clause 42 by inserting a new subclause "(3)(b) incentives for a regulated water services provider to improve cost efficiency,."

Recommendation 6: Amend clause 42 by inserting after the word "purposes" in the current subclause (3)(b)(vii) the words "or for a remuneration pool for the provision of a cost efficiency performance incentive scheme".

1. Introduction

Te Waihanga, the New Zealand Infrastructure Commission, welcomes the opportunity to provide feedback on the Water Services Economic Efficiency and Consumer Protection Bill. We refer to "the EECP Bill" where confusion is possible and to "the Bill" otherwise. We also refer to water service providers (WSPs) when discussing the Bill and to water services entities (WSEs) when discussing the Water Services Legislation (WSL) Bill and the Water Services Entities (WSE) Act 2022.

Te Waihanga was established in 2019, with a requirement to develop and publish a 30-year infrastructure strategy for New Zealand. This was achieved with the publication of Rautaki Hanganga o Aotearoa – the New Zealand Infrastructure Strategy (the Strategy). The Strategy was tabled in Parliament on 2 May 2022 and the Government expects it to inform policy initiatives in the infrastructure sectors, including in the three waters sector. The following box highlights provisions in the Strategy specific to the water sector.

Rautaki Hanganga o Aotearoa – the New Zealand Infrastructure Strategy

Specific provisions relating to New Zealand's water infrastructure include:

*Good incentives are needed to provide quality water infrastructure at an affordable cost (p.*84*).*

Water and wastewater metering and water conservation can reduce water use and wastage (p. 84*).*

*Improve water infrastructure pricing and provision in cities (*Rec 12*).*

*Reduce pressure on water infrastructure through better water management and conservation (*Rec 13*)*

The Strategy emphasises the critical importance of improving the efficiency and productivity of our infrastructure sectors. Infrastructure projects, including those in the three waters sector, are amongst the largest investments New Zealand can make. These high price tags mean that future generations often pay for decisions made in the past.

Te Waihanga also submitted on your discussion paper 'Economic Regulation and Consumer Protection for Three Waters Services in New Zealand', published on 27 October 2021.

2. Context for our report

2.1 International trends and experience

It is important to understand international trends and experiences to inform New Zealand's regulatory arrangements for the sector. The emergence of water retail markets and contestability initiatives, discussed below, have relevance to New Zealand's reform agenda.

The wholesale segment of the water industry accounts for about 90% of the final water bill in England, and so in that respect contestability in the wholesale market may be more important than introducing retail water markets. However, retailer choice may assist with creating pressure for wholesale market innovation.

2.2 Retail water markets

Retail water markets work in a similar way to retail markets for gas and electricity. Consumers choose which retailer to buy services from, and can switch at any time, for any reason and without penalty

(unless they have agreed a fixed term contract). A market code and market operator are needed to coordinate consumer switching and ensure other processes run smoothly. A market regulator is needed to enforce and evolve the code.

At this stage, only Scotland and England have introduced competitive retail water markets, and *only for business consumers*. We engaged Capital Strategic Advisors Limited (CSA) to investigate the applicability of retail water markets to the New Zealand context and prepare a brief report.[1]

The key findings from CSA's report include:

- Retail water markets could be adopted in New Zealand once the initial phase of the three water reforms have been completed. These markets work best when the retail functions of the water services entities operate at arm's length from the wholesale side of those businesses. The aggregation and corporatisation of the sector makes retail separation more feasible than under current arrangements.
- Market operators and regulators are already in place for the gas and electricity sectors and could easily be extended for the water sector.
- Introducing retailer choice for business customers could provide value for New Zealand, even though it would be a small market. The Scottish retail market is small and yet it appears to be outperforming the English market.

2.3 Contestability initiatives in the English wholesale water market

The economic regulator for the English and Welsh water industries, the Office of Water (Ofwat), has been introducing competitive discipline to all aspects of the wholesale side of the industry. We engaged CSA to prepare a report summarising those initiatives and discuss whether they are beneficial for English water consumers.[2]

The monopoly entities undertaking wholesale activities are called *wholesalers* in the CSA paper. Their activities mostly involve sourcing water, treating and transporting it to consumers, removing and treating wastewater from consumer premises, and metering water volumes.

Water sourcing

Ofwat has been encouraging the development of a water bidding market, a bilateral market and a water trading market.

In the water bidding market, third-party providers submit bids to water wholesalers to provide solutions to help them meet their future water needs. Solutions can either be on the supply side (eg, new water sources) or on the demand side (eg, water efficiency schemes to reduce the use of water). To date, not much new third-party activity has occurred since the water bidding market was initiated.

The bilateral market goes a step further than water bidding. It is where a third-party owner or operator of a water source can leapfrog over the existing wholesaler and contract directly with a business user of

[1] *Overview of retail water markets in the UK*, prepared by Capital Strategic Advisors Limited for Te Waihanga, 15 July 2022. Available at https://www.tewaihanga.govt.nz/policy/reports/

[2] *Overview of contestability initiatives in the English wholesale water market*, prepared by Capital Strategic Advisors Limited for Te Waihanga, 4 August 2022. Available at https://www.tewaihanga.govt.nz/policy/reports/

water or with the retailer serving business users. Both parties then seek to reach an agreement with the wholesaler for the conveyance of the water from its source to its use. This policy is not yet fully developed, and so bilateral competition has not commenced.

Water trading refers to the physical transfer of large volumes of raw or treated water from one wholesaler to another, typically through the physical interconnection of the water networks. Most water trading agreements were implemented before England's water wholesalers were privatised in 1989, and since then the volume of traded water has remained at about 4% to 5% of total volumes. The flat trading volumes have occurred despite Ofwat introducing targeted incentives in 2014 to encourage more water trading. Ofwat has committed to retaining the incentives until 2025 as it views water trading as a long-term project.

Transporting and treating water and wastewater

Ofwat is pursuing two contestability initiatives, called direct procurement for customers (DPC) and new appointments and variations (NAVs).

Wholesalers were already tendering out a lot of their construction work. DPC goes a step further than this, as it sets a process for wholesalers to competitively tender for a third party to design, build, finance, operate and maintain infrastructure. If the tender delivers better value for money when compared with the wholesaler retaining operation and maintenance responsibilities, then the monopoly wholesaler has to outsource the work as a design-build-operate contract.

NAVs arise where new water assets need to be installed within a wholesaler's service area, such as where a large housing estate property is being developed. These assets are often called an embedded network, as they are embedded within a larger network.

Prior to the NAV regime, the property developer could choose an accredited party to lay their pipes etc. but if it did that it had to transfer the ownership and operation of the embedded assets to the monopoly wholesaler for the area. These transfers can be administratively costly for both parties as they involve complex issues around how to value the assets.

Under the NAV regime, the developer has the choice of having a new appointee undertake the installation, ownership, operation and maintenance of embedded assets. NAV numbers are growing extremely quickly, with new NAV licences last year accounting for about 20% of all new homes built last year.

Managing and disposing of wastewater sludge

Ofwat refers to a bioresources market, which relates to the transporting, treating, recycling and disposing of wastewater sludge. Ofwat believes this market is potentially significant, as sludge can be used as an agricultural or forestry fertiliser, provide methane for electricity generation, or used in producing other products.

Ofwat expects wholesalers to think about their bioresources as a separate market from their other wastewater functions of sewage collection and treatment. To encourage this approach, Ofwat has introduced requirements for companies to separately price their bioresources and to disclose information about their commercial arrangements to improve incentives and create greater transparency.

In its 2021 market monitoring report, Ofwat stated that the trading of bioresources is very low and falling and that companies continue to report barriers to competition. Ofwat is currently considering additional initiatives to address these issues.

Should New Zealand pursue similar wholesale initiatives?

CSA states that the Ofwat initiatives are promising, but notes that only the NAV initiative appears to be bearing fruit at this stage. If New Zealand were to consider similar wholesale initiatives, it will be important to gather more evidence to form a considered view on whether to pursue them.

Ofwat emphasises the environmental benefits of these initiatives and works closely with the Environment Agency on many of them. The contestability for embedded networks is widely viewed as very positive for adapting to climate change because having them installing and operating embedded networks often leads to better approaches to managing heavy rainfall than when the monopoly water companies undertake those activities. According to Ofwat, the new parties are often more flexible than the water companies, attracting the support of Environment Agency officials.

In many respects, Ofwat has been clearing a new path, with many of its wholesale initiatives requiring significant ongoing development and refinement. In terms of the design of New Zealand's regulatory regime, it is important to allow the economic regulator sufficient discretion to develop fit-for-purpose initiatives.

In discussions with David Black, the Chief Executive of Ofwat, about the key lessons for New Zealand, he stated that:

> "… the most important thing is for the New Zealand regulator to have discretion to develop fit-for-purpose pro-competition initiatives. Too little discretion makes it difficult for the regulator to implement the right kind of initiatives to promote competition and results in long delays until legislative change can be made."[3]

We have therefore recommended that the WSL Bill provide sufficient flexibility for the Commerce Commission to adapt its regulatory approaches over time.

2.4 Flexibility for charging stormwater fees is important

The characteristics of stormwater services are very different from drinking water and wastewater. The primary beneficiaries of drinking water and wastewater are the users, who can be charged o the basis of their usage. A variety of pricing mechanisms can incentivise efficient resource use (such as volumetric charging to reduce demand or trade waste charges to moderate the quality of effluent), and the ownership of infrastructure is relatively easily defined.

In contrast, stormwater services are a public good, comprised of both green and grey infrastructure requiring maintenance not easily recovered via user fees. The causers of adverse stormwater impacts are often difficult to define and the downstream beneficiaries of stormwater systems are often not physically connected to reticulated stormwater networks. The success of these networks relies on assets in third party ownership, including roads as secondary flow paths, parks and reserves used for high flow detention and waterways held by a variety of owners. In the absence of a pricing system that directly

[3] Op. cit., p12.

connects stormwater services to their users, rates and other levies such as impervious area charges are effective and readily administered.

We engaged Sapere Research Group, an economics consulting firm, to consider the complexities associated with charging for stormwater services, how they are addressed in other comparable jurisdictions and present options for funding and pricing stormwater infrastructure services.[4]

Sapere's report assesses alternative pricing approaches according to efficiency, fairness, ability to provide full cost recovery, and administrative criteria (transparency, simplicity, and practicality). They find that current funding approaches in New Zealand (ie. rates) score well on administrative criteria but provide little to no incentive for improved stormwater outcomes.

Key findings from Sapere's review of international experience include:

- The perceived fairness of stormwater charges has been a critical consideration in the design of stormwater fee structures, particularly in the United States, leading to efforts to align charges with estimates of runoff, consistent with the polluter pays principle.
- For efficiency reasons, some international jurisdictions have structured their stormwater fees to align with each property's contribution to stormwater impacts. These include measures of property area, imperviousness (at neighbourhood or property level) and other hydrological factors.
- The available international evidence suggests such pricing structures have had a limited impact on behaviour and stormwater outcomes, as property owners have infrequent opportunities to make decisions that affect runoff and the cost in stormwater fees are small in comparison to the cost of new on-site stormwater infrastructure (e.g. permeable paving, rain gardens, rain tanks). Administration costs are also an issue with those approaches.
- To minimise administration costs and improve effectiveness, targeted incentive programmes should be considered to incentivise private landowners to invest in source control and green infrastructure.

The Sapere report reviews the potential challenges with the transition to water services entities, which arise in large part from the complexity of existing arrangements. Sapere recommends:

- Water services entities be given flexibility to choose how they set stormwater fees and incentives (including discounts or direct payments) to landowners, or other entities responsible for stormwater assets. Greater flexibility is particularly important to enable WSE's the ability to trial innovative and targeted programmes.
- Although stormwater services share some connection to the other water services, the interdependencies are insufficient to require co-development with the pricing of water and wastewater services.

[4] Murray, K., Tooth, R., Ira, S., and Z. Hartmann. 2023. *Stormwater pricing study: A report for the New Zealand Infrastructure Commission/Te Waihanga – Final*, 2 February 2023. Available at https://www.tewaihanga.govt.nz/policy/reports/

- Stormwater fees should not be harmonised within each water services entity. Rather they should consist of a component specific to each local council and an entity-wide component that reflects cross-entity costs. The local component is important because:
    - Urban areas require more costly grey infrastructure to manage stormwater, price harmonisation would generally lead smaller, rural areas subsidising urban centres. In this instance price harmonisation would contradict the affordability outcomes for smaller and poorer communities motivating the Government's interest in three waters reform[5].
    - Local councils will continue to have significant influence over the costs that water services entities will incur for their council area through the specification of development standards, land-use and building consents, design and maintenance of roads and reserves etc. Charging a local component will encourage councils to work with them to achieve better outcomes.
- Water services entities should have the flexibility to charge councils rather than property owners directly for stormwater services.
    - This would simplify the transition, by enabling the water services entities to leverage the councils' billing systems, which councils need to use in any case to charge ratepayers for any residual stormwater services they provide.
    - Stormwater services are predominantly a public good and similar to other council services (such as community infrastructure) provided to ratepayers. Allowing water services entities to charge councils for stormwater services would reduce the risk water services entities are seen as imposing a tax on ratepayers.
    - Councils will continue to have significant influence/control over the water services entities costs. Although councils will on-charge to ratepayers, charging them directly should further encourage them to manage their activities to reduce costs whilst also adhering to the Value for Money provisions of s.17A of the Local Government Act 2002.
    - A concern with charging to councils is that it could undo the benefits of balance sheet separation with the WSEs. It is not clear if this is a significant concern and there appears no reason to restrict the WSEs and councils adopting alternative arrangements if they are mutually beneficial.
- The Crown and other entities should pay their way.
    - Most Crown land is currently exempt from rates that are currently used to fund stormwater services (this includes land occupied by schools, universities and hospitals).

[5] New Zealand Government (2022) "Transforming the System for Delivering Three Waters Services: Summary of Proposals." Te Tari Taiwhenua - Internal Affairs. p24. https://www.dia.govt.nz/diawebsite.nsf/Files/Three-waters-reform-programme-2022/$file/Three-waters-reform-case-for-change-and-summary-of-proposals-15-June-2022.pdf.

- Consistent with Productivity Commission recommendations that central government should pay rates on its properties, we consider it appropriate that the Crown and other exempt entities should contribute to stormwater development contributions and fees. This is also consistent with the Crown's obligations to safeguard safety and the public good.
- The WSEs should also have flexibility in its financial arrangements with these entities to incentivise improvements in stormwater management.

2.5 Corresponding amendments arising from our recommendations on the WSL Bill

The charging provisions in Part 11 of the WSL are far more prescriptive than necessary, especially when compared with the approach in the Water Industry Act 1991 that governs charging arrangements in England and Wales.[6] Under that Act, water companies can charge water users directly and the Act leaves the economic regulator with total freedom to adopt pricing principles and regulate pricing practices it believes are consistent with its statutory objective. We believe a similar approach should be adopted in the Bill.

Adopting as far as possible an enabling approach, rather than prescription, is key to lifting infrastructure productivity, reducing costs and improving the overall performance of the water sector. An enabling approach is essential for the charging provisions in the WSL Bill, and to that end we have recommended that eleven charging-related sections be deleted. However, we also recommend specific amendments if these sections are retained, three of which require Commerce Commission approval.

Liability for water services charges

In broad terms, section 321 in the WSL Bill requires water services entities to charge property owners rather than water consumers. In our view it is particularly important to leave water services entities with the option of charging water users directly, as occurs in England and Wales. A direct relationship with consumers improves the ability of the water services entities to influence consumption behaviour. The presumption should be that water services entities charge water users directly where that is administratively feasible and efficient.

We have therefore recommended s. 321 in the WSL Bill be deleted but if it is retained then we have recommended it be amended to allow water services entities to adopt alternative liability arrangements if approved by the Commerce Commission.

Stormwater charges

The WSL Bill requires water services entities to apportion stormwater costs for an area based on the capital value of a property and specifies property owners as liable for stormwater charges. In our view, there is no reason to adopt legislative provisions precluding water services entities using the best methods for the circumstances, provided appropriate checks and balances are in place.

[6] The charging provisions in the Water Industry Act 1991 are at https://www.legislation.gov.uk/ukpga/1991/56/part/V/chapter/I#commentary-c13220441

We have recommended that sections 340 and 341 in the WSL Bill be amended to allow water services entities to adopt alternative approaches to charging for stormwater services provided, in each case:

(a) the water services entity has a methodology documenting why and how it wishes to adopt alternative approaches to charging stormwater fees; and

(b) an independent assessment of the methodology in subsection (a) has been undertaken by a suitably qualified party showing the alternative approaches are likely to be consistent with promoting efficiency; and

(c) the Commerce Commission has affirmed the independent assessment in subsection (b) suitably considers all arguments, facts and evidence and makes reasonable conclusions based on that analysis; and

(d) the Commerce Commission has affirmed the alternative approaches to charging for stormwater do not materially inhibit the effectiveness of the Commission's regulation of the water services entity.

Charges on unconnected properties

Section 339 in the WSL Bill enables water services entities to levy charges on the owners of unconnected properties provided certain technical criteria are met. Whether these levies can be considered to improve efficiency requires a weighing of the evidence about the pros and cons and on practicalities.

We engaged Capital Strategic Advisors Limited (CSA) to examine what occurs currently and consider the efficiency arguments for and against such charges. CSA reported results based on data from 51 out of 67 councils, finding that only 30 imposed levies in 2019.

CSA also found that:

- Wastewater levies are typically equal to 50% of household wastewater charges.
- Water supply levies vary significantly across councils, as some of them charge volumetric fees and *a standard fee* to cover their fixed costs and others charge a single *annual fee*:
    - Eight councils set their levy at 100% of their standard fee.
    - Most other councils set their levy at 50% of their annual fee.
- The current levies are likely to significantly reduce performance incentives for some water networks. However, removing the current levies may have little impact on the performance incentives of water services entities, as the impact depends on the objectives pursued by their boards and the approach the Commerce Commission takes to incentivising performance.
- If the Commission's performance incentive scheme is focused on the overall performance of each water services entity, then the scheme will reinforce the effects of geographic price averaging. However, if it is calibrated on the performance of each network within each water services entity, it could counteract the adverse impact that retaining the levies have on performance incentives.

CSA concludes that water services entities should be prohibited from charging unconnected parties unless they have an independent assessment undertaken by a suitably qualified party showing the charges promote efficiency and the quality and reasonableness of that assessment is endorsed by the Commerce Commission. This is because:

- The water services entities have stronger incentives than councils to set the levy too high and apply it more broadly than justified. The incentives on local authorities were checked by their proximity to the affected communities and by their accountability to electors.
- The case for retaining or removing the levies depends on whether the benefits of better performance incentives exceed the costs of greater bypass inefficiency. This trade-off depends on the design of the Commission's regulatory incentive scheme, which the Commission will know better than anyone else.
- Moreover, the levy affects network performance through its effect on consumer choice and competition from suppliers of stand-alone facilities. Consumer choice and competition are matters the Commission has considerable expertise and experience evaluating and addressing.

We recommended that section 339 in the WSL Bill be amended by prohibiting water services entities imposing these levies unless they have:

(a) a methodology documenting why and how it wishes to charge persons owning property not connected to the water services entity's water supply or wastewater network; and

(b) obtained an independent assessment by a suitably qualified party showing the methodology for charging unconnected properties is consistent with promoting efficiency; and

(c) the Commerce Commission has affirmed the independent assessment in subsection (b) suitably considers all arguments, facts and evidence and makes reasonable conclusions based on that analysis; and

(d) the Commerce Commission has affirmed that charging unconnected properties in accordance with the methodology in subsection (b) will not materially inhibit the effectiveness of the Commission's regulation of the water services entity.

Consequential amendments to the Economic Efficiency and Consumer Protection Bill

Recommendation 1: Amend clause 51 by inserting a new subclause stating "(2) The funding and pricing plans in subsection (1) may include–

(d) methodologies for adopting alternative liability arrangements for charges for water services; and

(e) a methodology documenting why and how it wishes to adopt alternative approaches to charging stormwater fees; and

(f) a methodology documenting why and how it plans to charge persons owning property not connected to the water services entity's water supply or wastewater network.

Recommendation 2: Amend clause 52 by making the existing clause subclause 52(1) and inserting new subclauses (2) and (3) as follows: "(2) If the Commission considers that–

(c) Any independent assessment provided to the Commission under section 51(2) does not suitably consider all arguments, facts and evidence or does not make reasonable conclusions based on that analysis, the Commission may direct the board of a regulated water services provider to not adopt the methodology.

(d) Any methodology provided to the Commission under section 51(2) materially inhibits, or is likely to materially inhibit, the effectiveness of the Commission's regulation of the water services

provider, the Commission may direct the board of a regulated water services provider to not adopt the methodology.

(3) For the avoidance of doubt–

(c) Section 52(a) requires the Commission to form a view about whether the independent assessment meets the standards reasonably expected of that type of analysis, having regard for the facts and evidence reasonably available to the independent assessor; and

(d) If the Commission affirms an independent assessment–

(i) the Commission is not implying the independent assessment reflects the quality of analysis the Commission would have achieved; and

(ii) the Commission is accepting the conclusions in the independent assessment are ones reasonably open to the assessor, and the Commission may have made different conclusions had it undertaken the assessment."

3. The timing of Commission oversight of major water investments is too late

3.1 Economic regulation will be a key driver of better sector performance

Alan Sutherland, Chief Executive of the Water Industry Commission of Scotland (WICS), argues the economic regulator needs the power to closely examine investment proposals at the same time, or shortly after, the water services entities are operational. Because of the high capital costs of water networks, Sutherland argues:

> "The economic regulator needs to be able to take a hard look at the investment proposals by the water network companies, in contrast to the relatively hands off approach to lines company investments. It needs to be more akin to the approach the Commerce Commission takes with electricity transmission investments."[7]

Another consideration is the importance of efficiencies in the wholesale side of the sector for liberalising the retail side. Both Scotland and England have introduced competitive retail water markets for business consumers. The Scottish retail market appears to be particularly successful, in part because it was introduced shortly after economic regulation of the wholesale side commenced.

WICS reported last year the retail market was delivering:

- Significant environmental benefits due to the reduced level of water consumption – since market opening, water consumption has decreased by 20%, reducing the operational carbon footprint of the industry.
- Lower prices and more tailored services - consolidated and electronic billing has resulted in savings and reduced administration costs for customers.

[7] *Overview of retail water markets in the Uk*, prepared by Capital Strategic Advisors Limited for Te Waihanga, 15 July 2022, p22. Available at https://www.tewaihanga.govt.nz/policy/reports/

- Additional services, such as different methods of payment, automatic meter readers and advice on how to improve water efficiency or reduce wastewater discharges. Customers have been prepared to pay for these value-adding services, foregoing price reductions that may otherwise be available.[8]

3.2 We endorse the speeding up of the introduction of economic regulation

Section 26(2) in the Bill allows information disclosure regulation to apply before the initial input methodologies have been determined, which are scheduled to start by 1 July 2026. We endorse this approach. A prudent approach for water services providers would be to work with the Commerce Commission as soon as possible to influence the input methodology relating to information disclosure, and we understand Watercare has been doing this. However, if they do not, then clause 26(2) in the Bill empowers the Commerce Commission to implement information disclosure regulation from 1 January 2027.

Similarly, sections 22 and 23 in the Bill allow for bringing forward the date by which price-quality regulation can start for the water services provider serving the Auckland and Northland areas. This regulation could start as early as the first regulatory period, which is scheduled to start on 1 Jan 2027. We endorse this approach, as it goes some way to addressing the above concerns about a long delay in introducing price-quality regulation.

3.3 However, Commission oversight of major investments needs to be introduced more quickly for all water services providers

The timeframes in the Bill mean three of the four water services providers are likely to be operating for six years, necessarily making significant investment and pricing decisions, before coming under price-quality regulation.

It takes considerable effort to develop price control arrangements, and so it is likely the Commerce Commission will initially adopt a modest price control regime. If the Commission adopts its usual 5-year regulatory periods, the risk is that it will not be until 2035 before it requires water services providers to adopt more sophisticated incentives and pricing arrangements, such as those in England and Scotland.

In our view, it would be desirable to amend the Bill to enable the Commerce Commission to have oversight of major water services provider investment decisions (eg, in excess of $20 million) from 1 July 2024, prior to formally adopting price-quality control in 2030. A corresponding amendment to the WSL Bill could be made to prohibit water services entities undertaking investments exceeding $20 million that have not been approved by the Commerce Commission.

Concerns about the capacity of the Commerce Commission to start scrutinising water network investments from 1 July 2024 could be addressed by providing additional funding for the Commission to

[8] Water Industry Commission for Scotland. 2021. *Invitation for expression of interest: Establishing a market health check for the non-household retail market*. p11. Available at https://wics.scot/system/files/2021-12/Market%20Health%20Check%20Information.pdf.

bring in appropriate water investment and regulation experts from Scotland, England, Australia and elsewhere, perhaps for a transition period.

The other avenue for bringing forward the price-control regime would be to get the information disclosure regime in place by 1 July 2024 (one year after Royal Assent of the EECP Bill) and reduce the length of the first regulatory period to one or two years. Achieving these milestones would allow price-quality regulation to begin on 1 July 2026 at the latest.

In our view these dates should be achievable by the Commission subcontracting a lot of its developmental work to other parties and adopting transitional input methodologies. The information disclosure regime doesn't need to be perfect or comprehensive first time round and can be closely modelled on the disclosure regimes the Commission already has in place for other utilities.

Although a fast-tracked approach would require additional funding for the regulator, water networks are a capital intensive industry. In our view, the additional funding is likely to be repaid many times over with better investment decisions over the 2024 – 2030 period.

4. More flexibility is desirable in the price-quality regulation of water services providers

4.1 More clarity is needed about which Act takes primacy

We are concerned the charging provisions (Part 11) in the WSL Bill are more prescriptive than necessary, especially when compared with the approach in the Water Industry Act 1991 that governs charging arrangements in England and Wales.[9] Under that Act, water companies can charge water users directly and the Act leaves the economic regulator with total freedom to adopt pricing principles and regulate pricing practices it believes are consistent with its statutory objective. We believe a similar approach should be adopted in the WSL Bill.

If the prescriptive charging provisions in Part 11 in the WSL Bill are retained, we are concerned about how the price regulation provisions in the EECP Bill reconcile with them. In broad terms, clause 12 in the EECP Bill states the purpose of price and quality regulation is to promote outcomes consistent with those in competitive markets such that regulated water services providers have incentives to innovate, invest, improve efficiency and provide services at a quality that reflects consumer demands (among other outcomes). However, several of the charging provisions in Part 11 in the WSL Bill appear to preclude pricing arrangements that one would expect to see in competitive markets.

For example, section 331 in the WSL Bill appears to preclude time-of-use pricing and pricing to ration demand (often called scarcity pricing). We note subsection (1)(c) states charges should be consistent with the input methodologies and determinations made by the Commission, however it is not clear what that means in practice when the Commission's requirements conflict with the pricing principles in the WSL Bill. Further clarity is desirable in our view.

[9] The charging provisions in the Water Industry Act 1991 are at https://www.legislation.gov.uk/ukpga/1991/56/part/V/chapter/I#commentary-c13220441

Another example arises with respect to section 340 in the WSL Bill, which requires water services entities to apportion stormwater costs for an area based on the capital value of a property. Targeted incentives may be more effective in motivating property owners to address the risks of stormwater run-off.

Recommendation 3: The Bill be amended to make it clear that targeted incentives, including time-of-use charging and scarcity pricing, are permissible.

4.2 The definition of consumer needs to better capture unconnected parties

The WSL Bill allows water services providers to charge water levies on the owners of properties that are not connected to the water network. As they do not receive any services from the network, levy payers are not customers of the water service providers, nor are they consumers as usually defined for economic regulation.

Clause 7 in the EECP Bill seeks to address this oddity by defining *consumer* as a person who– (a) consumes or acquires water infrastructure services; and (b) in respect of stormwater infrastructure services, pays for those services. Although this is an improvement on a previous version of the Bill, it is still inadequate: the levies are imposed on unconnected parties and the parties do not receive a service in exchange for paying those levies. In that sense, it may be contested that unconnected parties acquire services from water services providers.

It is very important Part 2 of the EECP Bill covers charges on unconnected parties, as water services providers have incentives to set those charges too high or too broadly. Conversely, as unconnected property owners are paying fees to water services providers, it is important they have rights to complain and seek resolution of their complaints through the consumer protection regime in Part 3 of the Bill.

A straightforward solution, to remove all doubt, would be to replace "acquire" with "is liable to pay for" in part (a) of the definition of consumer. This will ensure any party paying for water infrastructure services are included in the definition of consumer even if they do not receive services from the water services provider. This aligns with the definition of consumer of stormwater infrastructure services in part (b) of the definition, which recognises payers do not necessarily receive a service.

Recommendation 4: Amend clause 7 by replacing "acquire" with "is liable to pay for" in part (a) of the definition of consumer.

5. Cost efficiency incentives should be in the Bill

5.1 Incentives are needed to encourage cost efficiency

Clause 42(3) in the EECP Bill states that a price-quality path may include incentives for a regulated water services provider to maintain or improve its quality of supply. However, the Bill does not mention incentives to innovate and improve cost efficiency, which is essential to reduce prices and improve affordability for consumers (or minimise price rises to maximise affordability).

This omission appears to be an oversight as the title of the Bill includes economic efficiency and ensuring affordable water services as a key objective of the Ministers introducing the EECP and WSL Bills:

> "Once passed the legislation will ensure affordable drinking water, wastewater and stormwater can be provided to New Zealanders now and into the future. … These Bills are an important step

in addressing a fundamental cost of living issue that will affect all New Zealanders for decades to come if left unfixed."[10]

One effect of introducing financial incentives is that it may encourage water services providers to resist geographically averaging their prices. This might be thought to contradict one of the Government's key motivations for aggregating the country's water networks, which is to encourage cross-subsidisation to make network maintenance and upgrades more affordable for smaller and poorer communities.[11]

Conversely, however, if water services providers do average their prices geographically, then they face weaker incentives to manage their costs well and innovate to achieve cost efficiencies. This is because the benefits of achieving cost efficiencies in one location will be spread across all of their customers, typically allowing far smaller price reductions than if the savings were spread locally. This in turn weakens incentives for local stakeholders to support and work collaboratively with water services providers to identify cost saving opportunities.

Moreover, the presence of multiple stakeholders at governance and management levels and the wider geographic coverage of the entities seems likely to result in weak incentives for cost control. Moreover, innovative incentive schemes may be needed as the water services providers are non-dividend paying entities (refer section 5.2 below). This is likely to require a period of trial and error, and a degree of tolerance from the regulated entities and from Ministers.

Both considerations mean regulatory performance incentives are probably even more important than for other utilities.

In our view, it is critical the Commerce Commission has the flexibility to adopt incentive schemes that encourage cost efficiency, just as it does for electricity lines businesses subject to economic regulation. The Commission has considerable experience with developing and applying what it calls *incremental rolling incentive* schemes to other utilities. We imagine incremental and rolling approaches would also be appropriate for water services providers.

Recommendation 5: Amend clause 42 by inserting a new subclause "(3)(b) incentives for a regulated water services provider to improve cost efficiency."

5.2 Novel performance incentive should be explicitly allowed

In a regulatory setting, financial performance incentives work by allowing regulated entities to maintain higher prices for a period, such as five years, at which point prices are reduced. For example, a quality-linked incentive scheme allows providers to charge higher prices than they would otherwise be allowed to charge if their service quality exceeds the targets set for them and lower prices if their service quality falls short.

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[10] New Zealand Government. 2022. "New Legislation to Provide Affordable Water Services for New Zealanders." 8 December 2022. The Beehive. Accessed December 22, 2022. https://www.beehive.govt.nz/release/new-legislation-provide-affordable-water-services-new-zealanders.

[11] New Zealand Government. 2022. "Transforming the System for Delivering Three Waters Services: Summary of Proposals." Te Tari Taiwhenua - Internal Affairs. p24. https://www.dia.govt.nz/diawebsite.nsf/Files/Three-waters-reform-programme-2022/$file/Three-waters-reform-case-for-change-and-summary-of-proposals-15-June-2022.pdf.

Cost-linked incentive schemes work in a similar manner. Regulated entities, whether they are an investor-owned firm or a consumer or community trust, are allowed to earn profits for a period after reducing their costs, and then they are required to reduce their prices. Whereas an investor-owned firm distributes its profits to shareholders, a consumer or community trust distributes them to the trust's beneficiaries. A consumer trust is likely to reduce its prices rather than accumulate surpluses for distribution to beneficiaries, but it need not (it will also depend on the trust deed).

As mentioned above, one of the issues with introducing financial incentives for water services providers is that they are non-profit entities and are prohibited from paying dividends to their owners, which are the local councils. This means any cost savings will need to be passed onto consumers in the form of lower prices, shortly after the cost savings are achieved. Similarly, allowing the entity to charge higher prices for five years for over-achieving on quality is not feasible, as the entity needs to charge prices close to its costs to avoid making profits on an ongoing basis.

This raises the issue of whether financial incentives can effectively incentivise the board, management and staff of water services providers. To the extent they are personally motivated by reducing prices for consumers, they will want to reduce costs anyway and no financial incentive scheme is needed. However, not everyone will be price motivated, and so providing financial incentives aligns everyone's financial interests with the interests of consumers.[12]

Given these issues, we suggest the Commerce Commission should have the flexibility to develop novel incentive schemes. One possibility, for example, could be a pool of funds ringfenced for spending on management and staff remuneration, such as annual bonuses. It would be left to the boards of water services entities to develop and implement appropriate incentive arrangements. Another pool could be set aside for directors, to be divided pro rata to their normal fees. Both pools could have incremental and rolling features to them. Other value for money approaches should also be considered.

We recommend it be made explicit in the Bill that the Commerce Commission has the flexibility to develop new incentive schemes to provide effective performance incentives to water services providers.

Recommendation 6: Amend clause 42 by inserting after the word "purposes" in the current subclause (3)(b)(vii) the words "or for a remuneration pool for the provision of a cost efficiency performance incentive scheme".

The above recommendation does not require the Commission to ring-fence such funds, but adopting the recommendation would make clear Parliament's intention that the Commission will need to think innovatively in regard to developing effective performance incentives.

[12] We note a Cabinet paper from the Office of the Minister of Commerce and Consumer Affairs, entitled Economic Regulation and Consumer Protection in the Three Waters Sector, expressed a concern at paragraph 59 that the lack of dividend-paying ability may mean penalties and fines may not always make sense.