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to: New Zealand Productivity Commission

**Submission on: *Local government funding and financing***

My submission is entirely on the three waters aspect of Local Government. Because your report is obviously within the context of the Government's three waters reform agenda, this submission addresses that more generally, rather than stay entirely in the context of your draft report.

My background for this submission is a career largely within local government water engineering and management, including positions of:

- Chief Engineer and Manager Water Auckland Regional Council,
- Director of Works, Auckland Regional Council,
- Chief Executive Watercare Services Ltd,
- General Manager Water, Brisbane City Council

These positions encompassed moves to commercial structures and completion of domestic water metering for the two respective cities.

**Capital Intensity:** The water industry is highly intensive. Measured by ratio of asset value to income it stands well clear of any other utility service. Both sides of the ratio cause this. Firstly the assets are very long lived. Service lifetimes on dams and pipes can reach 100 years and on treatment plants and pump stations approach 50 years. On the income side, that is suppressed by:

- Free capital on which no return is required, from developer contributions
- Past reluctance to fully fund depreciation / capital consumption
- Viewing customers as identical with owners so a return on capital being traded for lower prices
- Consistent with the last, services funded through rates being driven by rates minimisation and in parallel with this, excessive loan funding of capital works
- Political reluctance to meter water
- Where a transition to full economic pricing might have been contemplated the full valuation of sunk assets has always been a deterrent.

**Metering:** The effect of metering is not simple, or the experience of new metering simply translated from one place to another. It does depend on factors related to garden watering, which include climate, soil and lot sizes. The general rule is for a reduction in excessive summer use and better attention to leakage. Where water is metered several of the items listed above under capital intensity mean that prices are often less than full cost accounting would indicate. However because of the very low price elasticity of water the economic damage from this is limited. Off-setting underpricing is an increasing trend to also charge for sewage through the water use. This results in marginal prices well above long run marginal costs for the volume component of water and sewage services, but again because of low price elasticity the economic damage is limited. Metering should not be a universal prescription, but for growing areas it should be a default to be tested to see if the alternative is viable. However if more commercial like ownership structures are to be used, there needs to be an alternative method of charging to universal use of meters. The bodies will need to be able to charge by connection rather than volume in circumstances where metering is not warranted. This is not by use of rating powers of owners.

**Three Waters:** Stormwater is fundamentally different from the other two waters. Its capital funding is much more dominated by developer contributions, there is no simple charging mechanism that can apply other than property rating and it is difficult to conceive any feedback from charging to behaviour. Most importantly the mechanisms for managing stormwater such as impervious area management, local infiltration, retention structures on properties and in streams are almost entirely within the role of the Resource Management Act and hence available for use through Local Body Plans and their management of consents. Any Council Controlled Organisation that attempted to run a business in stormwater disposal provision would find itself hopelessly compromised about powers which cannot properly be delegated by a Council. There is a crossover where inadequate sewerage systems impact stormwater but, in my view this is not sufficient to drive the two services together. This service is best left with Councils and it should continue to be funded through property rates and managed like other land related issues.

From here on my comments relate to only water and sewage provision.

**Regulation:** It is apparent from recent issues that there are problems with safe water provision and compliance with wastewater consents. Water regulation in other jurisdictions covers Value, Service and Quality, often separately, and they are worth considering separately.

**Value:** Covers prices and considers return of investment. With virtually no private water or sewage service providers in New Zealand this has always been left to local body owners to moderate. Unless the Government is determined that there should be an economic return or on forcing a transition to private provision there seems little benefit in regulating value. If however some local body owners wish to make this transition, then the need may eventuate.

If larger units do eventuate, a common outcome is often for them to use financial security and income streams from city areas to improve the services to smaller outlying areas within their area or responsibility. This can result in cross subsidisation, by harmonised “postage stamp” pricing that does not reflect local costs. In an extreme case West Australia had a

single price structure across the whole state. Such is not unknown in other Council services and there is some community tolerance of it. The powers of the Commerce Commission can apply in cases of gross abuse.

**Service:** Water New Zealand members have finally achieved voluntarily a mostly admirable set of industry performance reports<sup>1</sup>. This is sometimes called ‘yard stick’ regulation as it sets standards largely by comparison. On many measures there is no universal standard. The report’s one serious failing is that it fails to identify to customers how their local provider is performing. Some providers do self-identify in reporting to their Councils, but this does not suffice as a national system. Nor do all providers participate. Having come so close on self-regulation of service standards it seems irrational to consider a separate regulator for the service aspect. Some compulsion on inclusion and on identification seems all that is necessary to have the Water New Zealand system as sufficient. The exception that might be if value were to be regulated, then value has to be measured against service and allowable returns linked to service performance. Without that link though, the industry near self-regulation is to be preferred, provided it is enhanced.

**Quality:** This seems to be the most serious failing.

For **water** the standards are set by an appropriate national health authority and are consistent with international standards. Compliance is self-regulated to the large extent and is a practical combination of tests, methods and response to departures. Not all providers are covered (small size), some do not report consistently, and some are not in compliance. There is a clear scale difference between large centres where there is reporting and compliance and smaller centres where there are more frequent failings. Scale capability seems to be implicated. The results of compliance reporting are reported nationally but the consequences of failures to providers are minimal.

For **sewage** failure to renew or comply with discharge consents under the RMA appears to be a problem. While there are finally national standards requirements under the RMA these will not have yet flowed through into existing consents. An old problem has been a reluctance on the part of Regional Councils to enforce compliance on other branches of local government with expected cost consequences. This may be continuing.

Is a **central regulator** the answer? For water it seems wrong to move setting the standards away from the central health authority which has a broader overview of health needs, yet a regulator outside that agency without standard setting powers will be constrained in its effectiveness. For sewage the largely devolved standards setting through RMA consents would have to be questioned. Having the standards set locally but enforcement fully centralised would potentially be incongruous.

Some statements on a central water regulator rather lightly compare it to regulators for other utilities. It would be quite different. No other utility regulator has our health or the quality of our waterways in their hands. Establishing such a regulator and displacing others is not a small task. It has considerable risks.

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<sup>1</sup> Water New Zealand 2017-18 NATIONAL PERFORMANCE REVIEW [https://12240-console.memberconnex.com/Attachment?Action=Download&Attachment\\_id=3696](https://12240-console.memberconnex.com/Attachment?Action=Download&Attachment_id=3696)

In my view a central water regulator covering all aspects is not needed.

There is not a need for **water or sewage value** in the current, or likely ownerships.

For **water and sewage service** the industry only needs to finish its self-regulation work, on supplier identification and coverage. It may need some regulatory encouragement.

For **water quality** standard setting should remain with the **Ministry of Health**, but its coverage be extended to small supplies and a regime of carrots and sticks put in place for compliance, run by them.

For **sewage quality** the standard setting should continue to be devolved, but an agency needs to be charged with monitoring the reach of national standards into consistent RMA plans and consents, requiring quality performance reporting to national level through the regional councils and with sticks to apply to regional councils who do not respond and the ability to by-pass them to force compliance on consent holders. In my view this agency should be the **Environmental Protection Authority**.

**Scale:** As noted larger water undertakings have a lower frequency of water quality problems. It is not clear if this relationship also holds with sewage. Clearly the professional capability is higher or more focused in those larger organisations to achieve the water outcome. New Zealand is exceptional in the small size of many of its undertakings, and as well in the infrequency of commercial structures (like CCOs) put around them. The size of water undertakings in their geographic spread does not often of itself require scale. They are typically local. However the efficiency to be gained in shared professional direction, professional management and targeted shared services is considerable.

Running water and sewage together in single organisations is a universal standard and not worth re-investigating.

It has been suggested that a national reform on the Scotland model (one national provider) or the English (sizeable local private providers) or common Australian models (sizeable local corporatised providers in State or grouped Local Government ownerships) would correct the scale problem. In my experience of this transition it would provide this, as well as greater focus on customers and the industry fundamentals and clearer disciplines around price setting and capital expenditure. However the report indicates that it believes this is happening of its own volition. It is not. In Auckland it was forced by national government. Considerations of grouped service providers were rejected in at least Taranaki and Otago, and the Wellington example goes only part way (see the next section). It is unrealistic to expect local government to reform itself in this sphere. If it is to happen then central direction will be needed. If such reform is undertaken the pressure to improve water and sewage quality standards would be enhanced but should not be replaced.

Joint ownership of entities does require some ownership / governance structures and overhead costs but provision for these already exists and has to some extent been exercised already.

**Assets Inclusion:** As noted above the water industry is uniquely capital intensive. A consultant I once worked with who had broad water industry experience across the English speaking world had concluded that the undertakings that performed best had made smart capital investment decisions on scale, timing and technology, usually decades earlier. In short if you are to get the best results in a capital intensive industry you need to have a very sharp focus on capital expenditure. Operational

expenditure is important but cannot be a sole focus. An industry model such as Wellington's, with a common commercialised operator / maintainer, but the assets owned by the constituent Councils, and them providing capital to their local needs and making their own decisions on asset renewal strategies, is simply not the best way to go. Your report suggests it as a compromise. It is a non-optimal one.

**Right of Service Legislation:** Other utilities such as gas, electricity and telecoms have a legislated basis to their right to service, controlling their right to site services in road reserves, control access to them, control connections to their services. Such powers for water and sewage lie entirely in the Local Government Act. This has the bizarre outcome of corporatised water utilities continuing to rely on the by-law making powers of their parent local governments, most oddly in the case of controlling what may be put into sewers by industry, where only a trades wastes by-law will suffice. This works for the moment but if privatised entities were ever in prospect, it would not. In the case of a corporatised entity commonly owned by several local authorities it would be more efficient to have right of service legislation accessed by the utility rather than rely on individual by-laws. It would avoid the risk of beggar-thy-neighbour behavior, by for instance making charges for service locations in roads.

*In summary:*

- The capital intensity of the water industry is singular and requires different attention from other utilities.
- Further water metering is a potentially valuable part of water services but is not a universal need.
- If reform of water and sewage is required, then stormwater should remain with Councils as at present.
- The health and environmental quality aspects of the regulation of water and sewage are not comparable to other utility regulators and should not be changed lightly.
- A single regulator for quality, service and value is not needed or desirable. Quality needs attention and new powers to existing agencies should suffice.
- There will be economic, quality and service benefits from operating water and sewage together in larger units.
- Assets must be included in the ownership of any new larger units.
- A Water Services Act is needed, like for other utilities, to set out the operator rights.

Yours faithfully

A handwritten signature in black ink, appearing to read "Gary Law". The signature is written in a cursive, flowing style.

R G Law