

## Submission on the Local government funding and financing Draft Report

### Introduction

The Productivity Commission has presented a proposal for economic regulation of three waters sector (the Proposal) in its draft report on the funding and financing of Local Government (the Paper). This Proposal derives from a Research Note provided by Carl Hansen of Capital Strategic Advisors (CSA). The Productivity Commission has asked for submissions on the Paper.

This submission focuses on the Proposal and its potential impact on the three waters in New Zealand. It does not address other matters raised in the Paper, unless there is a contradiction between the outcomes of the Proposal and the findings and recommendations in the Paper.

The Proposal to regulate three waters sector should not be implemented because the Proposal;

- Contradicts the requirements of the Local Government Act (LGA), and will not deliver the objectives the Government is aiming to achieve with its programme for three waters reform.
- Does not align with established economic regulation, meaning its implementation is not possible in its current form.
- Relies on an incomplete understanding of how the three waters operates, which leads to it presenting suboptimal solutions.
- Is at odds with a number of the recommendations and findings of the Paper, leaving stakeholders unsure of how the Productivity Commission is delivering the terms the inquiry.

Discussion of each of these points is in the attachment at the end of this submission.

### Alternatives to implementing the Proposal

There is no doubt that improvements are required in the three waters sector. The question becomes what are the best means to deliver those improvements with the Proposal not going forward.

Regardless of any decision to apply economic regulation to the three waters, the Government three waters reform will be establishing a specialised drinking water regulator to ensure people can access water that is safe to drink. This will deliver compliance with requirements for protect sources, take a multi-barrier approach and improve water safety planning. It may involve water suppliers changing their operating models and establishing new ways to deliver services. It is not feasible to implement this regulator and a new economic regulatory system at the same time. Nor is it possible to produce good quality economic regulation if the basis of the industry is changing. A better approach would be to address the urgent need to improve water safety, and then assess the need for economic regulation once the changes have bedded in.

When that time comes, New Zealand can learn from the economic regulation that applies to the three waters sector in overseas jurisdictions. However, these are predominately in areas where privately owned providers are extracting profits from the provision of monopoly services. This is not the case in New Zealand, where the majority of three waters services are provided by Local Government on a not for profit basis. There is growing concern about the application of the default

model of economic regulation applied in these cases, which is the model the Proposal is endorsing.<sup>1</sup>  
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A better model for New Zealand to learn from is the work of the Water Industry Commission for Scotland (WIC), which provides economic regulation for Scottish Water. Scottish Water is the publically owned three waters provider and Scotland is generally comparable to New Zealand in a number of areas like population and civil structure etc. WIC had been operating the default regulatory model, but recognised the issues involved and upgraded to a model delivering better quality decision making and outcomes for customers.<sup>4 5</sup>

WIC applied the upgraded model to its latest decisions<sup>6</sup> and expects that the new process will deliver several benefits- including introducing much more flexibility into the investment planning process. The changed model should also identify opportunities for alternative approaches and innovation. This could include, for example, involving customers, communities and other stakeholders in the co-design and co-delivery of improvements. These improvements are not possible - or at the very least much harder- to realise under traditional regulatory approach endorsed by the Proposal. However, they align closely with the outcomes sought in the Government's three waters reform and offer a useful starting point when the time comes to consider if the three waters should be subject to economic regulation.

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<sup>1</sup> Oxera and Cave (2018), 'Regulation 2018: 'back to basics'', <https://www.oxera.com/agenda/regulation-2018-back-to-basics/>

<sup>2</sup> Oxera (2018), 'Legitimacy and renationalisation: where next for utility regulation', <https://www.oxera.com/agenda/legitimacy-renationalisation-utility-regulation/>

<sup>3</sup> Helm (2019), 'The Systems Regulation Model', <http://www.dieterhelm.co.uk/regulation/regulation/the-systems-regulation-model/>

<sup>4</sup> The Ethical Business Regulation (EBR) model from Professor Hodges from the University of Oxford. See Hodges, C. and Steinholtz R. (2018), 'Ethical Business Practice and Regulation: A Behavioural and Values-Based Compliance and Enforcement', Civil Justice Systems. See also Hodges, C and Steinholtz R. (2017), 'An International Adoption of Ethical Business Regulation', The Foundation for Law, Justice and Society. Hodges, C. (2016), 'Ethical Business Regulation: Understanding the Evidence', Department for Business Innovation & Skills, Better Regulation Delivery Office.

<sup>5</sup> Water Industry Commission for Scotland, "Strategic Review of Charges 2021-27 – Methodology Refinements and Clarifications (November 2018)". [https://www.watercommission.co.uk/UserFiles/Documents/VB2140%20WICS%20Methodology%20update\\_8.1.pdf](https://www.watercommission.co.uk/UserFiles/Documents/VB2140%20WICS%20Methodology%20update_8.1.pdf)

<sup>6</sup> Water Industry Commission for Scotland, "2019 Decision Paper 1: Asset Replacement". [https://www.watercommission.co.uk/UserFiles/Documents/2019%20Asset%20Replacement\\_Final.pdf](https://www.watercommission.co.uk/UserFiles/Documents/2019%20Asset%20Replacement_Final.pdf)

## Attachment: Discussion on the reasons not to support the proposal

This attachment provides more detail and discussion on the four reasons leading to the conclusion that the Proposal should not be implemented. The reasons are that the Proposal;

- Contradicts the requirements of the Local Government Act (LGA), and will not deliver the objectives the Government is aiming to achieve with the three waters reform.
- Does not align with established economic regulation, meaning its implementation is not possible in its current form.
- Relies on an incomplete understanding of how the three waters operates, which leads to the presentation of suboptimal solutions.
- Is at odds with a number of the recommendations and findings of the Paper, leaving stakeholders unsure of how the Paper is delivering against the terms the inquiry.

*The Proposal contradicts the requirements of the LGA, and will not deliver the objectives the Government is aiming to achieve with the three waters reform.*

The Proposal is based on several unjustified assumptions. These assumptions include that a profit motive is the only means to drive improvements in performance of the three waters suppliers. This is not the case as can be seen with the publically owned Scottish Water and with the performance of other non-profit entities. This assumption has resulted in the consideration of a very narrow scope of solutions, while alternatives have been overlooked. Some of the issues this produces are outlined below.

The Proposal assumes that the three waters services are, or should be, seeking to maximise profits. Neither Local Government nor any operating Council Controlled Organisation (CCO) in the three waters space operate on a for profit basis. By subjecting three waters operations to economic regulation the Proposal hopes to provide incentives to improve performance. This form of regulation is based on providing incentives to those regulated to maximise their profits. For a publically owned non-profit business, the assumption that it will respond in the same way to profit maximising incentives as a private company is questionable. In addition if a Local Government three waters operation was economically regulated the impact of that regulation would not affect a shareholder with loss of profits while lower costs are passed onto customers. Instead, the local community will lose out, as the economic penalties will mean there is less money that could be invested in the assets that provide services for them.

The Proposal attempts to define three waters assets as private goods rather than public ones using a narrow academic basis as a means to justify that a profit maximising objective should apply. This is despite the assets being owned by the community through Local Government, being legally prevented from privatisation, and providing what most their owners and consumers consider are public goods. It overlooks that an efficiently run publically owned operation is more productive than an equivalently efficient private owned enterprise. This is because funding costs are lower for public entities, and they do not have to pay dividends to owners. Instead, money that would otherwise leave the community can be reinvested back into services provided to ratepayers. Identifying the correct mechanisms to incentivise publically owned, not for profit, entities to be more efficient is a next step, but one where we can learn from the examples in Scotland and other places.

The Proposal is based on the premise that market signals, or the view of external financiers, are more valid than the voice of the customer. This ignores both that the customer is in effect the owner, and that the LGA specifically requires community engagement and

consultation.<sup>7</sup> It also is a failure to recognise that Local Government is required to consider more than just economics in their decisions; it must also encompass social, environmental and cultural well-being of communities.<sup>8</sup> A specific focus of the three waters reform is to include the view of Māori, which the Proposal is incapable of doing. The economic regulator is not empowered to take account of Māori interests as part of its consultation or decision-making. Despite calling for economic regulation, the Proposal is at odds with the view of regulatory specialists on the need for customer engagement.<sup>9 10</sup>

*The Proposal does not fully understand the Commerce Commission's role and does not recognise that the framework it recommends cannot be delivered under the current regulatory model.*

The Commerce Commission is an independent body that must follow a strict set of requirements in making its decisions. No decision on the need to regulate, or the form of regulation, can legally be made before the Commerce Commission carries out its own independent inquiry. The Proposal is that all water service providers are subject to economic regulation through an information disclosure regime and price quality regulation will automatically apply if performance targets are not met. In addition, the Proposal calls for assets and control to be removed from owners and given to another entity. None of this can be done under current legislation and it requires pre-empting Commerce Commission decisions. The Proposal will force an independent body to act both in a non-independent manner and against the law, losing any semblance of impartiality and credibility.

Arguments that legislation changes to accommodate the Proposal do not have any merit. If the current legislation does not apply for the three waters then this is an admission that the Commerce Commission's current regulatory framework, that is designed to apply to any industry, is not fit for purpose. The case the Proposal makes that the Commerce Commission is a credible industry regulator for the three waters, because of its current generic industry regulation role, collapses. This would also mean that the businesses currently affected by the Commerce Commission's decisions would have a strong case to overturn the economic regulation applying to them.

Even assuming that the regulatory framework changes to accommodate the Proposal, the Commerce Commission is not a credible three waters industry regulator. The Proposal assumes that an economic regulator is the same as an industry regulator but this is not the case. As an economic regulator, the Commerce Commission does not maintain specialist technical expertise. When its work requires judgement involving the technical management of assets, or similar non-economic inputs, the Commerce Commission contracts in specific technical expertise.<sup>11</sup> The Commerce Commission recognises the limits of its remit as an economic regulator and works with other agencies that affect regulated businesses, such as the Electricity Authority, in a structured manner in order to deliver its outcomes efficiently.<sup>12</sup>

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<sup>7</sup> Section 10, Local Government Act 2002

<sup>8</sup> Ibid

<sup>9</sup> Littlechild (2014), 'RPI-X, competition as a rivalrous discovery process, and customer engagement', <https://www.eprg.group.cam.ac.uk/rpi-x-competition-as-a-rivalrous-discovery-process-and-customer-engagement/>

<sup>10</sup> Littlechild (2011), 'Regulation and customer engagement', [https://www.eprg.group.cam.ac.uk/wp-content/uploads/2014/02/Regulation-and-customer-engagement-eeep\\_06\\_Littlechild.1\\_15.pdf](https://www.eprg.group.cam.ac.uk/wp-content/uploads/2014/02/Regulation-and-customer-engagement-eeep_06_Littlechild.1_15.pdf)

<sup>11</sup> <https://comcom.govt.nz/case-register/case-register-entries/alpine-energy-limited/media-releases/alpine-energy-warned-over-excessive-network-outages> is one example.

<sup>12</sup> <https://comcom.govt.nz/about-us/working-with-other-agencies>

Given this, the Commerce Commission cannot provide water sector leadership and deliver the requirement for a three waters industry regulator in a way that is credible and meets the requirements outlined in the Government's three waters reform.

*The Proposal is based on a lack of understanding of how the three waters operates and underestimates the complexity involved, which would lead to sub optimal outcomes if it was adopted.*

The Proposal assumes that the three waters are simpler or less complex than currently regulated services like gas and electricity. Those familiar with these industries, including overseas regulators, do not support this view. As an example, gas and electricity quality is not materially affected by distribution while water is at risk of contamination at any point in the network. This shows that even just the operation of a network is more complex in the case of the three waters.

The three waters sector has greater inherent risks and many unknown unknowns. New risks can appear quickly but take time to resolve. This does not fit the Commerce Commission model for setting cost and performance limits ex-ante, and not reopening the price path if the risks eventuate.

The Proposal equates supply failures in currently regulated electricity and gas businesses to be the same as a failure of water safety issue, when the resulting outcomes are materially different. An economic loss or measure of inconvenience is not the same as a community affected by environmental damage, sickness and deaths. Economic regulation by the Commerce Commission will not provide the right incentives to ensure the safety and wellbeing of communities.

Gas and electricity networks have very little interaction with the Resource Management Act compared to the three waters. A single three waters operation can have over a hundred consents, all of which have a number of bespoke conditions that must be met. In addition, the effects of all consents lodged by external parties on the three waters must also be evaluated and managed. This is inherently more complex than what currently regulated businesses deal with. Leaving this complex issue out when considering how to regulate the three waters will affect the quality of decision. This also weighs against the Proposals call for a single standard to judge environmental performance.

The Proposal assumes that stormwater has more in common with roading operations than it does with wastewater, and should not be part of three waters regulation. However, the performance of the nominally separate networks is so intertwined it makes no sense to consider one without assessing the impacts on the other. As an example, Auckland City is investing billions to upgrade the wastewater system to make improvements to stormwater outcomes. The systems are so similar that even when there are separate networks the same hydraulic models and criteria of design and operation are applied to each. Deliberately removing stormwater from any integrated regulation will put the efficient delivery of services to customers at risk.

The Proposal displays a survivorship bias in saying that the cases of universal metering being eventually accepted by the community proves that all universal metering schemes will be accepted. This overlooks all the cases where universal metering has been proposed but was not accepted by decision makers or the community. Accepting the assumption overlooks the

material risk that ratepayers and customers will not accept universal metering and capacity based charging. The argument that water leakage can only be controlled by universal metering is not valid. Even without universal metering other water providers have driven down leakage rates with extensive district metering to a level where private leakage can be accurately identified, and then applied other means of incentivising property owners to fix leaks.

The Proposal attempts to develop a pricing mechanism based on the capacity required to support individual metered consumption and encourage the provision of different services depending on customers' willingness to pay. By attempting to apply a market solution using an incorrect basis the Proposal will produce poor incentives and not meet the needs of communities. The reasons for this as discussed in more detail below.

The Proposal assumes that water consumption is the only service being provided and that all services provided can and should be charged to individuals. Unlike gas and electricity distribution, there are multiple services being provided beyond direct supply, and these services provide benefits to the community as a whole rather than individuals. These services includes the provision of firefighting capacity throughout the district and the provision of excess capacity and resilience to parts of the community like hospitals, community centres and supporting vulnerable people. The entire community benefits from these and fund them through rates or metered charges. However, charging individuals based on universal metering does not provide efficient investments to deliver these outcomes. Instead, it appears to be building in cross subsidies for these services.

Pricing on supply also assumes that customers will respond to price signals. A number of studies that show the price charged for water is irrelevant as a driver of consumption. Information on consumption volumes and patterns can be useful to change behaviour, but this is a separate matter than responding to price signals.

Also overlooked is that there is generally plenty of excess capacity for customers. Mains are sized to support Fire and Emergency New Zealand (FENZ) operations i.e. to meet fire flow requirements, not consumer's needs. The marginal cost is low and there is not a competitive need to allocate capacity requiring a market solution.

Another factor that has not been considered is that three waters providers are required maintain supply, even when payment is overdue.<sup>13 14</sup> This mutes the economic incentives that charging for consumption could apply. It is recognised that the benefits of maintaining hygiene and meeting minimum levels of supply outweigh any purely economic arguments.

The Proposal has ignored other relevant legislation in the development of a consumption based price. Currently the three waters industry already has legislation around the supply and charging for the provision of water services. For example, the charging of bulk water levy for Greater Wellington Regional Council supplying water to City Councils in metropolitan Wellington region is restricted to a uniform charge.<sup>15</sup> This, and any other legislation affecting the sale or export of the three waters, will need to be considered before setting any pricing requirements for water services. This is unlikely to be a simple process that can be done in the short time the Proposal recommends for the implementation of economic regulation.

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<sup>13</sup> Section 130, Local Government Act 2002

<sup>14</sup> Section 69S, Health Act 1956

<sup>15</sup> Section 86, Wellington Regional Water Board Act 1972

Similarly, the Proposal ignores the impact on any contracts in place on the provision of three waters services. These include joint ventures between Councils and contracts with third parties for services like the operation of treatment plants. Build, own, operate, transfer (BOOT) is a contract model where a third party owns the assets providing three waters services. By setting price limits under economic regulation and removing asset ownership, the Proposal is seeking to interfere with commercial contracts and the property rights of assets owners.

*The Proposal raises a number of points that deliver different outcomes to the findings and recommendations the Productivity Commission has made in the paper. This means the proposal is in conflict with the paper.*

In calling for the implementation of the Proposal, the Productivity Commission would leave stakeholders unsure what it is trying to achieve, what its aims are, and would call its advice into question.

The Paper calls for a reset of the regulatory relationship between Local and Central Government to one of partnership. Under the Proposal, Councils would be regulated to provide information of performance against measures they do not get to set, or even necessarily agree with. If they fail to achieve the standards, then they will be regulated by the Commerce Commission, their assets removed, and their ability to make the decisions required of them under the LGA will be compromised.<sup>16</sup> As outlined earlier, the Commerce Commission is independent and must make its decisions based on criteria that does not include any external agreements or protocols. It cannot consider a reset regulatory relationship, the agreements of other parties, allow co-design, signal its decisions or negotiate with participants without compromising its basic operating principles. The outcome of adopting the Proposal will be that the promise of a partnership between Central and Local Government is invariably compromised, and in such a way that Local Government will be the loser.

The Paper discusses and recommends various changes to financial and performance reporting for Local Government. As has been noted earlier the Commerce Commission is not bound by the needs of other entities, including reporting, and must design regulatory financial and performance reporting requirements for assessing the delivery against Part 4 of the Commerce Act. If the Proposal is adopted and the three water are regulated, then any financial and performance reporting recommended in the Paper will be redundant. It would simply add cost and complexity to Local Government reporting with no effect on behaviour, due to the far greater incentives imposed by economic regulation.

The Paper proposes a capital charge as an incentive for certain behaviours in a Council. The Commerce Commission sets its own incentive structure based on Part 4 of the Commerce Act. A capital charge is not included in any of its current regulation and, as the premise of the Commerce Commission is to apply the same general model to all regulated activities, is unlikely to be introduced. Adopting the Proposal renders the capital charge the paper calls for ineffective.

The Proposal calls for the economic regulation of water services. All price-quality regulated businesses have had a material write down in asset value, limits on revenue to be collected and controls over pricing imposed on them by the Commerce Commission. The Paper states

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<sup>16</sup> Sections 10, 11 and 14, Local Government Act 2002

that the valuation system and practices are outside of the scope set by the Government but is silent how the changes the Proposal calls for could affect these components.