

# Submission to the Ministry of Business, Innovation & Employment

## Economic regulation and Consumer protection regulation for three waters services in New Zealand

Te Waihanga NZ Infrastructure Commission welcomes the opportunity to submit on the discussion paper 'Economic Regulation and Consumer Protection for Three Waters Services in New Zealand', published by the Ministry of Business, Innovation & Employment (MBIE) on 27 October 2021.

Te Waihanga was established under the New Zealand Infrastructure Commission/Te Waihanga Act 2019. Our main function is "to co-ordinate, develop, and promote an approach to infrastructure that encourages infrastructure, and services that result from the infrastructure, that improve the well-being of New Zealanders".

Consistent with this function, our submission focuses on those aspects of MBIE's discussion paper that are relevant to promoting investment in, and the maintenance and operation of, three waters infrastructure in a manner that will improve the well-being of New Zealanders.

Our key points may be summarised as follows:

- We support the economic regulation of water infrastructure of the proposed Water Services Entities.
- Given the governance arrangements for the Water Service Entities are proposed to be bespoke and are subject to change through the reform process, the availability of robust economic regulation, focused on regulating price and quality, is critically important
- The first step should be putting in place information disclosure requirements, to support increased transparency around performance and governance for the benefit of consumers.
- Legislation should include provision for the ratcheting up of economic regulation, but only if it turns out to be necessary, as economic regulation is costly to administer and comply with.
- We support the establishment of an expert consumer advocacy body—overseas experience has shown that this will lead to better-informed regulatory decision making.
- Care should be taken to not conflate consumer protection regulation of three waters with the other forms of three waters regulation—in particular, economic regulation.

# Economic regulation of three waters

## Case for economic regulation of three waters entities [Q1, Q3]

Te Waihanga agrees there is a case for economic regulation of water infrastructure of the proposed Water Services Entities.

The Water Services Entities are natural monopolies. This creates a risk of excessive prices, restricted volumes, poor quality, and lack of innovation.

Water is an essential service, important to economic, social/health, environmental, and cultural wellbeing (including Te Mana o te Wai). Te Waihanga is concerned about the continuation of the long-term underinvestment in three waters infrastructure that has been identified. Te Waihanga also supports initiatives that promote more efficient water infrastructure spending. Consideration of the 'on what' and 'how' money is spent is as important as 'how much' (if not more important).

As such, we support proposals to promote better decision-making on infrastructure investment through:

- strong and effective governance
- reliable and timely information to guide decision making
- robust processes and transparency
- appropriate checks and balances on monopoly infrastructure.

The discussion document highlights the concern that the Water Services Entities will be less responsive to consumers, by virtue of their scale and having to meet multiple objectives and the demands of many stakeholders.

We share such concerns, but also note that the full proposal has many features that seek to align the interests of the Water Services Entities with their principals – current and future consumers – including through consumer advocacy functions. This detail has a bearing on the form of economic regulation, as we suggest below.

Our submission is based on the proposal as it currently stands. Considerable detail that is relevant to the question of economic regulation is still being worked through – including governance arrangements and questions of representation. Such detail could affect our view on whether and what form of economic regulation would be justified.

## Stormwater networks also subject to economic regulation [Q2]

A significant amount of work is still underway with respect to any transfer of stormwater responsibilities from local authorities to the Water Services Entities.<sup>1</sup> As such, it is premature for us to comment on the form of economic regulation for stormwater.

The situation reflects the complexity of stormwater networks – with multiple owners of both hard and soft/green infrastructure, and a lack of consistency in management, funding, regulation, and service levels around the country. The complexity increases risk, both of underperformance of the entities but also of regulatory failure.

That being said, the management of any stormwater infrastructure *by the Water Services Entities* should in principle be subject to the same economic regulation as drinking and wastewater services. This is

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<sup>1</sup> [https://www.dia.govt.nz/diawebsite.nsf/Files/Three-waters-reform-programme/\\$file/stormwater-technical-working-group-transition-plan-report-25-august-2021.pdf](https://www.dia.govt.nz/diawebsite.nsf/Files/Three-waters-reform-programme/$file/stormwater-technical-working-group-transition-plan-report-25-august-2021.pdf)

because the same concerns about inefficient investment in infrastructure apply. Further, different regulatory treatment would introduce the risk of inefficient incentives to re-classify expenditures to avoid more onerous regulatory requirements.

## Economic regulation should not apply to community and private schemes and self-supply [Q4]

Economic regulation should apply only to the Water Services Entities.

Te Waihanga agrees with MBIE that such regulation should not apply to community and private schemes or self-supply. These schemes are small-scale, their interests are likely to be closely aligned with their customers' interests, and compliance costs would likely outweigh any benefits. Further, it seems likely that the costs to consumers of such schemes are lower than the cost of being provided through the standard network services. Because of their scale, if consumers are not satisfied with water quality, or the cost of stand-alone water services are too high, they could seek alternative services. (While not viable everywhere, this could include seeking, and paying for, the expansion of and connection to reticulated water networks).

This question also highlights the importance of efficient pricing by the Water Services Entities. This is so that consumers can make informed decisions about investments in substitutes for network water services (such as rainwater harvesting, standalone wastewater treatment, and re-use of grey water).

## Learning approach to the form of economic regulation [Q5-7]

The consultation paper proposes economic regulation 'as a back-stop' to address the risk that the Water Services Entities become less responsive to consumers and do not achieve lower prices and improved quality. This risk is a function of:

- increased scale and distance from consumers
- increased complexity from multiple objectives and standards that must be met
- a wider set of stakeholders.

We note the large number of features in the proposal aimed at making the Water Services Entities responsive and accountable to consumers – though current proposals may yet change, and detailed legislative provisions will also matter.

Therefore, at this stage the more important issue at stake is information asymmetry:

- principals and agencies hold different information about what operational and capital spending is efficient to meet the various expectations and regulatory standards (including water quality and environmental performance standards), and this could lead to overengineered solutions
- uncertainty about benefits could cause (or continue) resistance to increased spending by the entity on the maintenance and upgrading of 'invisible' assets or on resilience, resulting in a continuation of underinvestment
- an economic regulator also suffers from incomplete information about what would be the 'right' amounts of capital expenditure or overhead costs. A strong expectation that the water reforms must deliver significant efficiency gains raises the risk of economic regulation being too tight, while the current problem is underinvestment in water infrastructure.

Hence, we consider the priority should be putting in place information disclosure requirements, to support increased transparency around performance and governance. This is consistent with the approach to economic regulation of consumer trust-owned electricity distribution businesses.

We suggest the legislation could include, as part of the Water Services Entities' functions, an explicit requirement that investment plans are supported with cost-benefit analyses/business cases. This would promote efficient water infrastructure spending and provide consumers with additional confidence about spending plans.

Te Waihanga notes that achieving efficiency gains is seen as 'pivotal' and agrees that the consequences of poor performance could be large for consumers. We also acknowledge that developing and applying an input methodology, for example, is likely a matter of years.

However, implementing and complying with price-quality regulation is also costly. Those costs go beyond the regulator's own costs set out in section 7 of the consultation document.<sup>2</sup> More information is needed to be sure that the benefits of additional regulation justify the costs. Further, there is a risk of regulatory failure, particularly when information is lacking. Such failure would also have costs, and thus also need to be considered alongside direct agency costs.

It will take time to implement a regulatory regime yield good quality information that is consistent over time and comparable across the Water Services Entities (and that facilitates comparisons with analogous organisations in other sectors and overseas).<sup>3</sup> We note this will be an input to more intrusive economic regulation should that prove to be required. Te Waihanga suggests that ease of access to unambiguous, consistent, and relevant information should be a priority.

More far-reaching economic regulation could be implemented later when agencies are established and more is known about the capabilities and performance of the Water Services Entities and their governing bodies, and the effectiveness of information disclosure. The legislation should include provision for the ratcheting-up of economic regulation (in case it turns out the proposed arrangements to make the entities responsive to consumers are insufficient). The realistic 'threat' of additional regulation, and the associated reputational cost, is likely to be an effective way to reinforce alignment of the Water Services Entities with their principals.

## Commerce Commission should be the economic regulator [Q17]

Te Waihanga agrees in principle with MBIE's analysis set out in Table 5,<sup>4</sup> which is that the Commerce Commission is the most appropriate body to be the economic regulator for the three waters sector.

The Commerce Commission has relevant expertise in the economic regulation of utilities which it can readily draw on. Placing the role with it would avoid the spreading of scarce expertise across different agencies, and minimise the establishment time and added overhead costs associated with establishing and running a new agency.

## Establish principles for efficient pricing [Q14]

Te Waihanga considers the use of economically efficient pricing is key to managing demand and supporting efficient investments in water infrastructure or its alternatives. We note pricing in three waters has been found to be inefficient and underutilised as a tool.

Clarity on who pays, and why, will become more important as investment in three waters infrastructure increases, and because the Water Services Entities service multiple communities, each with their own

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<sup>2</sup> P. 54.

<sup>3</sup> Te Waihanga is conscious about the limits of formal benchmarking when considering just the four entities. This could limit the effectiveness of economic regulation. (We also note section 53P(10) of the Commerce Act 1986 limits the use of benchmarking in price-quality regulation.) However, reliable and consistent information does provide opportunities for comparisons with water organisations internationally and other regulated industries to give broad insights about relative performance.

<sup>4</sup> P. 51.

characteristics and service requirements. (The latter also means it is unlikely that having uniform charges across Aotearoa would be efficient.)

Price reform will be fraught—it may change who pays what, and the necessary technology to get to some ideal pricing structures (such as smart water meters) may not be in place. Therefore, price reform is best seen as a process that will take time. It should provide for adaptation as requirements and technology change over time. However, it is possible to specify the underlying pricing principles at the outset (eg, prices reflecting economic cost, otherwise recovery of cost in a manner that least distorts behaviour; transparency; etc).

Te Waihanga considers that the overarching principle and focus for water pricing should be economic efficiency. This will contribute to the delivery of water services at least cost to consumers in the long run. Equity objectives are best addressed by central government through other social policy interventions that do not distort signals of the cost of providing networked water services to different communities.

Efficient pricing principles could be specified in legislation or else be developed and published by the economic regulator for the Water Services Entities to implement. The economic regulator should also be able to develop a pricing structure. However, there are benefits in providing the Water Services Entities a degree of control over pricing structures and the pace of change, so these can reflect the specific characteristics and circumstances of the regions.

## How should economic regulation be funded [Q18]

Te Waihanga considers it appropriate that economic regulation for the three waters sector is funded via levies on regulated suppliers.

Reasons are that this:

- aligns the costs of the regulatory regime with its beneficiaries – including that the substantial number of people not on major water networks do not have to pay for the regulation of major water networks
- promotes accountability of the regulator to payers
- is consistent with standard cost recovery guidelines such as those published by the New Zealand Treasury and Office of the Auditor-General.

# Consumer protection regulation

## Avoiding duplication in regulatory arrangements

As explained earlier, Te Waihanga's focus in this submission is on matters relevant to promoting investment in, and the maintenance and operation of, three waters infrastructure in a manner that will improve the well-being of New Zealanders.

While we understand the benefits of consumer protection regulation, it is beyond the scope of our functions. Therefore, we wish only to highlight the importance of clarity over what consumer protection regulation encompasses, as we see the potential for initiatives described in the discussion paper under consumer protection regulation to duplicate initiatives under economic regulation.

## Defining consumer protection regulation [Q21-22, Q31]

### What is consumer protection?

The discussion paper defines consumer protection as follows:

*Consumer protection refers to rules that aim to safeguard the interests of consumers and the general public against market practices that are misleading, deceptive, unfair or generally inconsistent with consumer welfare. Importantly, consumers can include both individuals and businesses that purchase goods and services.<sup>5</sup>*

Using this definition, consumer protection regulation therefore is designing, enacting and enforcing regulatory arrangements that safeguard the interests of consumers and the general public against the identified undesirable practices.

### The discussion paper's meaning of consumer protection regulation appears broader

We interpret the consideration of consumer protection regulation in the discussion paper to use a broader definition.

In places this reflects the status of the three waters reform programme. For example, we are uncertain what minimum service levels would come within the consumer protection regulatory arrangements and what minimum service levels would fall within the other regulatory arrangements for three waters. The discussion paper acknowledges this uncertainty—refer to footnote 48.<sup>6</sup>

In other places the discussion paper appears to conflate consumer protection regulation with consumer engagement in economic regulation. This is most apparent in the discussion in chapter 10 on how consumers should be given a strong voice about three waters. The mechanisms either proposed or suggested to achieve this appear to span consumer protection regulation and economic regulation.

For example, the paper asks whether the economic regulator should have a positive legislative obligation to incentivise high quality consumer engagement in order to strengthen the consumer voice in the three waters system. We consider that placing such an obligation on the economic regulator

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<sup>5</sup> Paragraph 159.

<sup>6</sup> Footnote 48 says:

*This list is provided to illustrate the range of issues that may not be covered by other regulatory provisions. However, because the various regulatory regimes that will apply to the three waters sectors are yet to be developed, or still developing, it is possible that one or more of the issues raised may be covered by these regimes.*

would be for the purpose of strengthening the consumer voice in the *economic regulation* of the three waters system rather than in the consumer protection regulation of the three waters system.

## Consider further the purpose statement for a consumer protection regime [Q21]

The discussion paper sets out the following purpose statement for a consumer protection regime for three waters:

*“The paramount objective of the consumer protection regime will be improving service quality to reflect the demands of water consumers, including through:*

- *enhancing the quality of water services over time (focussing on aspects of quality not regulated by public health, environmental or economic regulators)*
- *providing consumers with a strong voice in how water services are delivered*
- *providing consumers with effective redress where the quality of service does not meet appropriate standards*
- *providing consumers with transparency regarding water charges.*<sup>7</sup>

We recommend further consideration be given to this purpose statement, including:

- aligning the purpose statement more closely with the definition of consumer protection
- clarifying that for the entire objective, rather than for part of the objective, the consumer protection regime does not cover three waters matters regulated by public health, environmental and economic regulations
- clarifying which water consumers are covered by consumer protection regulation (eg, all water consumers; residential and small business water consumers; water consumers under a defined consumption threshold)
- testing implicit assumptions—for example, as drafted the purpose statement states that improved service quality is needed to reflect the demands of consumers of water. This may not always hold true across time and across consumers—that is, it will depend on consumers’ preferences and the quality of service in place.

## We support further consideration of an expert consumer advocacy body [Q32]

The discussion paper puts forward the option of establishing an expert body to advocate on behalf of consumers. We support the establishment of such a body. However, we consider more in-depth consideration of this body is required, particularly around its role(s).

From the standpoint of economic regulation, overseas research has shown that regulatory decision making is better informed by consumer advocacy bodies participating in regulatory price reviews for utilities. Consumer advocacy bodies broaden the information used in the regulator’s decision making.<sup>8</sup> We consider this a fundamental tenet in ensuring the economic regulation of three waters promotes investment in, and the maintenance and operation of, three waters infrastructure in a manner that will improve the well-being of New Zealanders.

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<sup>7</sup> Paragraph 166.

<sup>8</sup> See, for example:

- Fremeth, A.R., Holburn, G.L.F., & Spiller, P.T. (2014) The impact of consumer advocates on regulatory policy in the electric utility sector. *Public Choice*, 161, pp. 157–181.
- Fremeth, A.R., & Holburn, G.L.F., (2012) Information asymmetries and regulatory decision costs: an analysis of US electric utility rate changes, 1980–2000. *Journal of Law, Economics, & Organization*, 28(1), pp. 127–162.

We note the level of influence of a consumer advocacy body in the economic regulation decision-making process for water lies within a spectrum. At one end of the spectrum the consumer advocacy body responds to regulatory consultations on the price/quality of water services. At the other end of the spectrum the consumer advocacy body actively participates in negotiating the price/quality of water services, such as has occurred in Scotland.

We consider the level of influence of an expert consumer advocacy body in the economic regulation of three waters to be an important decision point. Amongst other things, it may influence the role of the economic regulator in three waters. While initially it may not be feasible to adopt the Scottish approach under the three waters regulatory reforms, we support this approach being a goal of three waters regulation.

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