

Submission on the Water Services Economic Efficiency and Consumer Protection Bill

Submitted to: the Finance and Expenditure Select
Committee

24 February 2023



Commerce Commission submission on the Water Services Economic Efficiency and Consumer Protection Bill

Introduction

1. The Commerce Commission (the Commission) appreciates the opportunity to make a submission to the Finance and Expenditure Select Committee on the Water Services Economic Efficiency and Consumer Protection Bill.
2. The Commission is an independent Crown entity and is New Zealand's primary competition, fair trading, consumer credit, and economic regulatory agency. Our vision is to make New Zealanders better off. We work to ensure markets work well and that consumers and businesses are confident market participants. Our submission is made on the basis of:
 - 2.1 our experience as the economic regulator for a number of sectors, including electricity, gas, airports, dairy, telecommunications, retail payment systems and fuel; and
 - 2.2 the Government's decision that the Commerce Commission will be the economic and consumer protection regulator for the three waters sector.
3. Our submission does not focus on the substantive policy positions contained in the Bill, but rather the general workability of the economic regulatory framework contained within the Bill from our perspective as the proposed regulator.
4. This submission is in two parts:
5. Part 1 sets out:
 - 5.1 How the Commission will apply economic regulation and consumer protection in the three waters context; and
 - 5.2 The Commission's view regarding timeframes for consumers to realise benefits from the reforms.
6. Part 2 sets out:
 - 6.1 The Commission's commitment to work with Māori in a meaningful and good faith way; and
 - 6.2 A specific request for clarification of engagement requirements within the Bill as they relate to the Commission's engagement with Māori.
7. The Commission appreciates the willingness of the Ministry of Business, Innovation and Employment in working with the Commission in shaping the Bill. We continue to work with the Ministry on a range of minor or technical matters that we consider may assist the Bill to operate as intended.

Summary of key points

8. Our key feedback can be summarised as follows:
 - 8.1 The proposed economic regulation and consumer protection regime is likely to play a useful role in achieving the Government's objectives regarding three waters services.
 - 8.2 The Commission supports the flexibility provided in the Bill regarding the use of economic regulatory tools. This reflects the structure and governance of the Water Services Entities (WSEs), the uncertainties about the incentives they will face, and what tools will best drive improvements in performance. The tools in the Bill include an ability to set performance requirements as an extension of quality standards, and flexibility for the regulator regarding the form of regulation applied to regulated entities.
 - 8.3 Based on our experience, we consider it will take time for the economic regulatory regime to mature and regulated entities to build their capacity and capability for efficient management of their assets. In addition, the likely outcome of the combination of efficiency gains and the impact of investment and tariff rebalancing requirements on prices faced by consumers is uncertain.
 - 8.4 We consider price quality regulation has particular value in the context WSEs as a 'credible threat' of regulatory escalation. This has worked well in the regulation of airports, where information disclosure alone has driven performance improvements. We therefore, support price-quality regulation coming in later, and the ability to defer if there is a case to support doing that.
 - 8.5 The Commission is committed to involving Māori in a meaningful and good faith way in our work under the Bill. The Commission has developed a Rautaki Māori (Māori strategy) which will guide us to improve internal capability and effectively bring Māori voices into our work.
 - 8.6 However, the Bill could provide greater certainty as to what is intended in regards to the Commission undertaking engagement with Māori in the context of making recommendations, determinations and decisions that take account of Water Services Entities' Treaty and other obligations. Clarity about whether engagement is intended to be limited to just these functions, or to apply more broadly such as to consumer protection matters or when the Commission is considering a recommendation to designate an unregulated WSE as a regulated WSE, would be helpful.
9. We elaborate on these points in the body of our submission.

Contact information

10. Please contact Ryan McLean, Principal Policy Analyst, Strategy, Policy and Performance in the first instance at [REDACTED] in relation to questions regarding the Commission's submission.

Part 1 - The Commission's views on economic regulation and three waters

11. This section sets out the Commission's views on economic regulation generally and applies these specifically in the context of the three waters reforms.
12. It also highlights the Bill, as it stands, creates a flexible and workable set of economic regulation and consumer protection tools that would support achieving the intention of the reforms. The purpose of Part 1 of this submission is to explain the basis for this view.

Economic regulation and consumer protection is likely to play a useful role in achieving the Government's objectives regarding three waters services

13. Economic regulation can be a powerful tool to drive improved performance and better outcomes for consumers from monopoly suppliers and in other markets that are not working effectively. In particular, economic regulation, in its different forms, can seek to:
- 13.1 shine a light on poor and good performance;
 - 13.2 constrain the ability of regulated entities to extract excessive profits from consumers;
 - 13.3 incentivise regulated entities to improve efficiency;
 - 13.4 improve the quality of service provided to consumers; and
 - 13.5 resolve information asymmetry that may arise between the owners, board and management of an entity.
14. Consumer protection regulation can help to promote informed decision-making by consumers, protect consumers from unfair practices, and work alongside economic regulation to drive better performance by regulated entities.
- 15.

Government objective	How economic regulation may be able to assist
Significantly improving safety and quality of drinking water services, and the environmental performance of wastewater and stormwater systems	To the extent that matters relate to the quality of drinking water this will primarily be for the regime administered under the Water Services Act by Taumata Arowai. However, the quality of infrastructure services will also have an impact on these objectives, which will be within the Commission's regulatory scope.

Ensuring all New Zealanders have equitable access to affordable three waters services	Economic regulation can promote efficiencies in the delivery of three waters services, resulting in more affordable services for consumers than in the absence of regulation. Depending on the contents of a service quality code, a consumer protection regime could also help drive equity by imposing protections for vulnerable consumers in respect of matters such as billing and hardship.
Improving the coordination of resources and unlocking strategic opportunities to consider New Zealand's infrastructure needs at a larger scale	Economic regulation can drive better availability of information on the quality of infrastructure and future infrastructure needs.
The need to address the impacts of climate change and ensure the resilience of water services	Economic regulation can support greater resilience of infrastructure by scrutinising asset management plans and setting quality standards or performance requirements that drive investment in more resilient assets.
Moving the supply of three waters services to a more financially sustainable footing, and addressing the affordability and capability challenges faced across the sector and particularly by some small suppliers and councils	A stable and predictable economic regulation regime, including the availability of high-quality information about the WSEs' performance, may support the financeability of the sector and provide ratings agencies with confidence about the capacity and capability of WSEs to finance their commitments.
Improving transparency and accountability for the delivery and costs of three waters services, including the ability to benchmark the performance of service suppliers	Information disclosure under an economic regulation regime can improve transparency and accountability and resolve information asymmetries between the proposed WSEs, regional representation groups, and their customers and communities.

The proposed structure of Water Services Entities has implications for the design and effectiveness of an economic regulation regime

16. The proposed structure, ownership and governance of the four WSEs, and the current state of water infrastructure in some parts of the country, has implications for the design and effectiveness of an economic regulation regime.
17. Relevant context and features of the proposed regime include:
 - 17.1 a lack of consistent good quality information about the state of much water services infrastructure or the performance of current suppliers;

- 17.2 sustained underinvestment in water services infrastructure by some current suppliers;
 - 17.3 the transition to the new WSEs is likely to be associated with substantial change, including to pricing ;
 - 17.4 issues around intergenerational inequity;
 - 17.5 there will be multi-layered governance arrangements; and
 - 17.6 there will be statutory recognition of te Tiriti, and obligations on the WSEs to give effect to Te Mana o te Wai.
18. The Commission has worked with MBIE to develop flexible interventions to incentivise improvements in the WSEs' performance, which are reflected in the Bill. In particular – at least in the initial phases of the reforms – there may be limited benefit associated with applying a traditional price/revenue path to the WSEs.
19. Typically, economic regulation seeks to improve the performance of regulated entities through some combination of:
- 19.1 use of information disclosure regulation to increase transparency about financial and non-financial performance allowing comparisons to be made over time and between entities;
 - 19.2 mandating quality, output, or other performance standards to ensure good-quality services are delivered to consumers and are not undermined by attempts to cut costs;
 - 19.3 use of price or revenue controls to limit excessive returns from being earned, incentivise efficiencies, and assess expenditure plans; and
 - 19.4 financial penalties and other remedies for non-compliance.
20. Each of the regulatory tools has particular benefits and can be used to target specific issues that arise. The appropriate selection of tools may therefore change over time and we support the flexibility in the Bill that enables this.
21. For example, price quality regulation will still be relevant to the WSEs and it can be used to achieve some of the objectives outlined. However the effectiveness of price or revenue controls and penalties for non-compliance on driving efficiency gains may be reduced by the WSEs' inability to pay dividends and lack of – in effect – equity holders in the WSEs.
22. Under economic regulation, controls on maximum allowable revenue can incentivise profit-making entities to reduce costs to allow a greater return to be provided to shareholders. Over time, these efficiencies are reflected in lower maximum allowable revenues for the entity, in this way efficiency gains are shared with consumers. However, this incentive is likely to be weaker for WSEs, because shareholders cannot benefit from, and are therefore less likely to demand, efficiency

improvements. WSEs cannot pay dividends nor can shareholders benefit from a gain in the value of the entity as it cannot be sold. Other tools, such as performance requirements may play a greater role in achieving these objectives in the water sector. Nonetheless, we consider price-quality regulation has value in this sector including as a credible threat of regulatory escalation. We support its inclusion in the Bill including the flexibility to defer the start date if there is a case to support doing so.

23. The prospect of financial penalties and other remedies can provide a strong incentive for regulated parties to comply with economic regulation requirements, as the penalties will lower the returns paid to shareholders. This means that shareholders discipline the entity to comply with regulation. However, while the reputational impact associated with a breach will still likely be strong, the imposition of a financial penalty is itself less likely to incentivise compliance, for similar reasons as mentioned above.

We are supportive of the additional tools and flexibility provided for in the Bill

24. The Bill provides the Commission with the tools to achieve the Government's objectives for three waters through the inclusion of:
- 24.1 more flexibility regarding the types of economic regulation applied than is provided for in Part 4 of the Commerce Act;
 - 24.2 an explicit ability to set performance requirements that extend beyond quality standards; and
 - 24.3 an ability to use comparative benchmarking to drive cost control in price quality regulation.
25. These are discussed in more detail below.

There is appropriate flexibility regarding the types of economic regulation applied

26. Given the unique proposed structure and governance of the WSEs, and the significant change the sector is likely to face in the coming years, applying economic regulation is likely to involve a process of learning and refinement in the early years.
27. The Bill includes a presumption that price-quality regulation will apply to the WSEs from the second regulatory period, and also provides an ability for the Commission to recommend that the form of regulation could be amended (i.e. that a WSE should no longer be subject to one or more forms of regulation). The Commission supports this flexibility.

An explicit ability to set performance requirements that extend beyond quality standards

28. Given the Government's objectives for three waters services – including in relation to quality, resilience, and efficiency – the Commission supports the Bill enabling the Commission to impose performance requirements as well as quality standards. We consider that the ability to impose performance requirements is desirable as a

complement or alternative to traditional price-quality regulation to incentivise improvements in performance.

29. Performance requirements:
 - 29.1 enable a direct mechanism for the economic regulator to impose some requirements that the Commission has previously done somewhat indirectly under Part 4 of the Commerce Act (either via information disclosure, quality standards, or a price path); and/or
 - 29.2 provide new tools for improving the performance of regulated entities.
30. For instance, the Bill provides the ability for the Commission to scrutinise and (in some circumstances) approve expenditure through a combination of information disclosure regulation and quality regulation (performance requirements).

An ability to use comparative benchmarking to drive cost control

31. The Commission supports the inclusion of a power to employ comparative benchmarking. This is not available under Part 4 of the Commerce Act.
32. Comparative benchmarking enables the regulator to assess the scope for greater cost efficiency of regulated suppliers. It uses information from a group of similar firms over time to try and better understand how their efficiency differs and what may be reasonable to expect of water suppliers. Many water regulators use this tool, for example, the Water Industry Commission of Scotland and the Water Services Regulation Authority (Ofwat) in the UK.
33. When price regulation comes into force, the Bill enables the Commission to use comparative benchmarking to set allowable revenues below existing cost levels to drive efficiency gains where appropriate.

Part 2 – Reflecting te Tiriti and the Commission’s engagement with Māori

34. The economic regulation regime can and should be sufficiently flexible to take into account Te Tiriti and Te Mana o te Wai.
35. The Commission considers it important that any economic regulation or consumer protection regime in the water sector is responsive to Te Tiriti o Waitangi and reflects Te Mana o te Wai. This will promote regulatory coherence, given the statutory objectives of WSEs regarding te Tiriti and Te Mana o te Wai set out in the Water Services Entities Act.
36. Our key feedback in respect of this issue is set out below. In summary:
 - 36.1 the Commission is committed to building its internal capability to understand Māori interests and te ao Māori, and to working with Māori in a meaningful and good faith way; and

- 36.2 the Bill should provide explicit, as opposed to implicit, requirements to engage with Māori and clarity as to what that involves.

The Commission is committed to building its internal capability and to working with Māori in a meaningful and good faith way

37. The Commission acknowledges that it has given limited consideration to Te Tiriti and te ao Māori in its work in the past. The Commission is committed to building its understanding of its role under Te Tiriti o Waitangi. We are beginning a journey to better understand te ao Māori and what it means for our work.
38. Recently the Commission has embarked on a programme of staff capability development and has employed staff with particular knowledge and experience in applying te Tiriti and engaging with Māori. We have also developed a Rautaki Māori (Māori Strategy) to guide us in both our internal development and in our engagement with Māori as we commit to bringing Māori voices into the Commission’s work. The Rautaki Māori focuses on:
- 38.1 **Working with Māori:** Competently working with Māori to ensure Māori feel comfortable engaging with us and their input is valued. This includes ensuring that we have tools and skills to build enduring relationships with Māori.
- 38.2 **Policies and Processes:** Look at our work with a kind but critical eye, to help us build inclusive practices that see more Māori working at the Commission and better outcomes for Māori impacted by our work.
- 38.3 **Cultural Capability:** This provides the foundation for all we want to achieve – that we can confidently and comfortably engage with Māori. This focuses us on our learning journey and building our knowledge.
39. The three focus areas will support and enable whānau, hapū, iwi and Māori engage meaningfully and in good faith with the Commission and provide the pathway for the Commission to ensure Māori are better off because they are confident market participants.
40. The Commission considers itself well placed to commence more meaningful, good faith engagement with Māori with a view of working with Māori to bring their voices and influence into the Commission’s work.

The Bill should provide explicit, as opposed to implicit, requirements to engage with Māori and clarity as to what that involves

41. The primary obligation on the Commission under clause 6 of the Bill is to “maintain systems and processes”. This obligation is intended to ensure that, for the purposes of complying with clause 5(2)(c), the Commission has the capacity and capability to uphold the principles of te Tiriti and to engage with Māori and understand perspectives of Māori.
42. While clause 6 could be read as implying that the Commission must engage with Māori, the clause does not explicitly require the Commission to engage.

43. As noted above, the Commission is committed to working with Māori in a meaningful and good faith way, and regardless of whether the Bill provides an implicit or explicit requirement, the Commission will seek to involve Māori in our work. However, the Commission prefers the Bill to be explicit in its expectations.
44. The Commission notes the importance of water to Māori as a taonga and notes submissions from individuals and iwi on MBIE's 2021 economic regulation discussion document¹ indicated a strong desire among Māori to work with the Commission.

Extending the scope of any Commission obligation to engage with Māori

45. Clause 6 only relates to engagement with Māori in respect of the requirement in cl 5(2)(c) to take into account of WSEs' Treaty-related and other obligations.
46. The Bill does not specifically contemplate engagement with Māori in respect of the Commission's other functions. We consider it could be clarified whether engagement is intended to apply more broadly such as to consumer protection matters or when the Commission is making recommendations under cl 64 to designate a water services entity.

¹ MBIE, "Discussion Paper: Economic Regulation and Consumer Protection for Three Waters Services in New Zealand", 27 October 2021. Available at <https://www.mbie.govt.nz/have-your-say/economic-regulation-and-consumer-protection-for-three-waters/>.