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Via email: 

Kia ora Charlotte

Price-quality path for Watercare – Approach Paper

Thank you for the opportunity to provide our submission on the Commission’s approach to developing Watercare’s first price quality path.

Our submission has been carefully considered. While we are raising concerns and suggestions for consideration, we are aligned and supportive of the fundamental principles proposed by the Commission, including the use of a Financial Capital Maintenance approach and the importance of financial sustainability. Our submission provides constructive input to the process of establishing a permanent regulatory regime with a robust methodology and rules that protect against unintended consequences, and which will enhance the confidence of customers, investors and financial markets. We are also cognisant of our role as New Zealand’s largest water services provider, and that the steps we take now will influence the success of the wider water sector reform process.

In our submission, we recommend extending the Watercare Charter by up to two years and adopting a more streamlined, proven approach to establishing our price quality settings. This would give Watercare and the Commission enough time to develop sound regulatory inputs, test key assumptions, and ensure the path supports financial sustainability, resilience, and the objectives of Local Water Done Well. It also provides the opportunity to consider some flexibility in the design, reflecting Watercare’s unique no dividend capital structure, which ensures all funds are only for customers’ benefit.

We recognise that our proposed approach would require changes to the current timetable, but we believe it is the right step to set up Watercare – and the wider sector – for future success.

We are very happy to meet at your convenience to discuss any aspect of our submission. We look forward to continuing our constructive engagement with the Commission as the enduring regulatory regime continues to take shape.

Ngā mihi



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Watercare Services Limited

Watercare Services Limited

Submission to the Commerce Commission on
Price-Quality Path for Watercare – Approach Paper

5 February 2026

[PUBLIC]

Watercare



Table of Contents

- 1. PRELIMINARY STATEMENT4
- 2. EXECUTIVE SUMMARY6
- 3. INTRODUCTION 14
- 4. STATUTORY PROVISIONS FOR ECONOMIC REGULATION 15
- 5. PROCESS FOR SETTING WATERCARE’S PQP 18
- 6. REVENUE BUILDING BLOCKS AND FINANCIAL CAPITAL MAINTENANCE24
- 7. INITIAL RAB AND FINANCEABILITY26
- 8. COST OF CAPITAL 30
- 9. AN ALTERNATIVE APPROACH32
- 10. RAB ROLL FORWARD METHODOLOGY35
- 11. OTHER DECISION-MAKING TOPICS FOR PQPS39
- 12. GLOSSARY 44

1. PRELIMINARY STATEMENT

1. Watercare shares the Commission's objectives for transitioning the water sector to enduring economic regulation and is dedicated to working closely with the Commission to implement this regulation consistent with the financial sustainability, revenue sufficiency and investment sufficiency objectives of water sector reform.
2. If well implemented, the regime will promote financial certainty and predictability, which will enable Watercare to continue to invest in critical infrastructure. This investment is necessary to provide water services which meet the expectations of Watercare's current and future customers and given Watercare's unique no dividend capital structure, all funds are used only for customers' benefit. Enabling the appropriate level of investment in the sector also underpins the purpose of the Government's Local Water Done Well programme and the introduction of an enduring economic regulation regime for water services. There is therefore a significant opportunity for the Commission to support the growth and sustainability of the water sector for the long-term benefit of consumers. The regulatory approach adopted for Watercare will also provide a framework for economic regulation for other water service entities, so the regulatory settings must enable additional investment in water services infrastructure across New Zealand.
3. Watercare considers there is a material risk that the benefits of economic regulation may not be realised in practice under the Commission's proposed approach. Accordingly, in this submission, we set out Watercare's views on alternative processes and methods for implementing price-quality regulation for Watercare.
4. Our proposed alternative process is to extend the Charter for up to two years, with appropriate adjustments and cross checks, as provided for in Part 6 of the Commerce Act. This would provide time for Watercare to prepare a more robust price-quality path proposal, reflecting the learnings from the Charter, feedback from verification and consultation processes, and better alignment with other plans and regulatory processes. It would also enable Watercare and the Commission to establish foundational regulatory settings including initial regulatory accounting information and building block revenue forecasts.
5. Extending the Charter would also provide more time for proper consultation on how financial capital maintenance should be implemented before setting Watercare's first price-quality path under Part 4 of the Commerce Act. This could be done via formal input methodologies; including regulatory methods in the price-quality path propose/respond process; or undertaking more comprehensive consultation on methods and options than is currently proposed.
6. Our proposed alternative methods for introducing a financial capital maintenance framework include using Watercare's audited establishment values from November 2010 to derive a deemed historical cost initial regulatory asset value. This initial asset value, along with a benchmark weighted average cost of capital allowance, depreciation allowance and forecasts of prudent opex and capex would be used to set Watercare's revenue allowance. A financeability test would be implemented at each price-quality path period.
7. We therefore encourage the Commission to fully consider the alternative methods proposed in this submission, even if it does not accept our recommendation for an extension of the Charter. Once determined, the initial asset value cannot realistically be revisited in the future to address adverse consequences. In Watercare's view, the proposed approach is not consistent with the financial capital maintenance principle or promoting regulatory stability and certainty. For these reasons, Watercare is not confident that the proposed approach would in fact support Watercare's ability to meet its financial sustainability and revenue sufficiency obligations. In practical terms, this could require Watercare to reassess and, if necessary, cut back, its capital delivery programme.

8. Watercare looks forward to working constructively with the Commission through the development and implementation of IMs and PQ regulation for Watercare and welcomes the opportunity to assist in the transition of the water sector into enduring economic regulation under the Commerce Act.

2. EXECUTIVE SUMMARY

9. This submission sets out Watercare's Services Limited's (**Watercare**) response to the Price-quality path for Watercare – Approach Paper, dated 26 November 2025 (**Approach Paper**). The submission is intended to assist the Commerce Commission (**Commission**) in implementing price-quality (**PQ**) regulation for Watercare that promotes the long-term benefit of consumers, consistent with the purpose of Part 4 of the Commerce Act 1986 (**Commerce Act**), while supporting the delivery of safe, reliable and resilient water and wastewater services.

Watercare supports a transition to a FCM-based framework

10. Watercare supports the transition of the water sector to enduring economic regulation and recognises the potential benefits of a building blocks framework underpinned by financial capital maintenance (**FCM**). Watercare is dedicated to working closely with the Commission to implement this regulation.
11. Watercare considers that its specific statutory, financial and operational circumstances - and those of the water sector more broadly - must be carefully considered in designing Watercare's PQ path (**PQP**). Unlike other regulated sectors, Watercare is entering into permanent economic regulation following an interim Charter regime¹ (**Charter**) designed primarily to ensure near-term cash flow sufficiency and investment financeability.
12. Watercare considers that an FCM-based framework is broadly consistent with the purpose in section 52A of the Commerce Act. When implemented appropriately, an FCM-based building blocks framework provides regulated suppliers the opportunity to recover the prudent and efficient costs incurred in providing regulated services. The FCM model supports access to capital markets and the financing of large, long-lived infrastructure assets that deliver services over time to multiple generations of consumers. It also provides a transparent and predictable framework for setting user charges over time.

Sufficient time to ensure appropriate implementation of FCM approach is critical

13. Whether FCM delivers outcomes consistent with funding needs, affordability and long-term financial sustainability depends critically on how the framework is implemented and maintained over time. The specification of foundational building blocks like the regulatory asset base (**RAB**), and cost of capital will materially influence funding profiles, cash flows and pricing trajectories across regulatory periods. These are critical to Watercare's investment sufficiency, revenue sufficiency and financial sustainability for the first PQP and over the longer term.
14. The Approach Paper provides limited information on these foundational building blocks and how FCM will apply in practice to Watercare. What information is available suggests departures from the standard building block approaches adopted for other regulated sectors in New Zealand and in other jurisdictions. There are no characteristics peculiar to Watercare or the water sector that justify unexpected departures from established regulatory practices.
15. It is proposed that core building blocks (including the initial RAB and cost of capital) will be addressed in a position paper (**Position Paper**) in mid-2026. There is to be no opportunity to provide feedback on the Position Paper, prior to the draft PQP decision due in late 2027. At that point there will be very little time available to consider alternative approaches and additional evidence before the PQP comes into effect on 1 July 2028.

¹ Local Government (Water Services Preliminary Arrangements) (Watercare Charter) Order 2025

16. Watercare considers that the process, timetable and sequencing proposed by the Commission create material risk that foundational regulatory decisions – including those for the initial RAB, cost of capital and regulatory accounting framework – are embedded without sufficient clarity, consultation or safeguards. Accordingly, there is a risk that the benefits of economic regulation may not be realised in practice, including the financial sustainability, revenue sufficiency and investment sufficiency objectives of the water sector reform. In this submission, we set out Watercare’s views on alternative approaches to key elements of the proposed approach to implementing PQP regulation for Watercare.

Input methodologies promote regulatory certainty and are therefore preferred

17. The risks identified above are heightened by the absence of upfront input methodologies (**IMs**), which in other regulated sectors provide regulatory certainty and predictability, transparency and discipline. In the absence of IMs, there is a risk that ‘indicative’ positions become *de facto* methodologies without the usual consultation and appeal protections. This approach risks undermining regulatory credibility and long-term consumer outcomes.
18. We note that regulatory predictability is critical to Watercare’s financeability. The regulatory framework and the FCM building blocks approach to revenue allowances will be essential considerations for our lenders and the credit rating agencies, when assessing Watercare’s financial performance. For example, ‘stability and predictability of the regulatory environment’, ‘cost and investment recovery’ and ‘revenue risk’ are all key rating factors that Moody’s has regard to when conducting rating assessments of water businesses, including Watercare. Hence, regulatory predictability is critical to Watercare maintaining an investment grade credit rating and accessing sufficient capital to meet our investment needs. Unwarranted departures from the well-established approach to building blocks risks our financial sustainability, particularly if they are implemented without the rigour of the IM process.
19. The IMs were designed as a mechanism to allow different views to be fully tested upfront, before PQ regulation was applied in other sectors. While the Commerce Act provides the Commission the discretion not to set IMs for water services prior to the first PQP, the Commission is also not prevented from establishing upfront IMs. Furthermore, the ability not to set IMs for water services does not give the Commission the ability to set the initial rules and processes (whether IMs or not) without following a proper process.
20. Upfront IMs (following the prescribed statutory process) are likely to better promote the Part 4 purpose when adopting a building blocks approach to determining maximum revenues consistent with FCM. This is because, while adoption of the concept of FCM is relatively uncontentious, the long-term benefits of the FCM principle to consumers is highly contingent on how well it is implemented in practice.

A transitional PQP through Charter extension better promotes the Part 4 purpose statement

21. This submission proposes that more staged approach should be taken to implementing PQ regulation for Watercare. In Watercare’s view, such an approach would better promote investment and revenue sufficiency, financial sustainability and the long-term benefit of consumers. It would provide the Commission with an opportunity to properly resource the development of robust and considered framework for PQ regulation. It would also allow sufficient time for Watercare to prepare a robust PQP proposal, and for independent verification, consultation and assessment of the proposal, while undertaking parallel regulatory workstreams. This would therefore allow for the PQ path determined under the Commerce Act to be more fit for purpose.

22. Our proposed transitional approach is that the PQ framework under the Charter is extended for a period of up to two years, with appropriate adjustments and cross checks, as provided for in Clause 31 of Part 6 of Schedule 1AA of the Commerce Act. Ideally this would provide time for IMs to be determined prior to Watercare providing its PQP proposal to the Commission.
23. The extension of the Charter could be based on the existing Charter settings being rolled forward with an appropriate growth rate, subject to price shock and financeability cross checks, and with similar compliance reporting for price-setting and performance outcomes.
24. Adopting an extension of the Charter PQ regulation framework would also enable Watercare to focus efforts on development of asset management plans before embarking on development of a PQP proposal. A delay of up to two years before adopting a PQP under Part 4 would provide sufficient time for:
 - 24.1. Watercare to prepare a more robust PQP proposal, reflecting feedback from independent verification, consultation and audit processes and the requirements on the Commission to assess the proposal (which is very challenging under the existing proposed timeline);
 - 24.2. Watercare and the Commission to establish foundational regulatory settings including initial regulatory accounting information and building block revenue forecasts;
 - 24.3. Watercare to align PQP proposal inputs with other plans and regulatory processes including in relation to information disclosure (**ID**) regulation and the Charter; and
 - 24.4. Watercare and the Commission to reflect more of the improvement plans, learnings and initiatives which are emerging under the Charter in the PQP proposal and decision. We expect these to enable us to deliver a more optimised expenditure planning approach, with appropriate prioritisation and phasing to ensure the plan is delivered and our target service outcomes are met.
25. In summary, an extension of the Charter for up to two years would provide more time and a greater opportunity for proper consultation on how FCM should be implemented before setting Watercare's first Building Block Model (**BBM**) PQP under Part 4 of the Commerce Act, using a propose/respond model.
26. Even if formal upfront IMs are not set, it is critical that Watercare and other stakeholders have an opportunity to contribute to and comment on the development of the core regulatory inputs and accounting decisions – currently proposed by the Commission to be addressed in the Position Paper prior to the draft decision.
27. Ideally upfront methods would be determined for all key regulatory inputs, drawing on well-established precedent, for cost allocation, asset valuation, cost of capital, form of control and regulatory processes such as reopeners and PQP proposal matters. We recommend that the approach adopted to these matters is informed by the existing IMs and the learnings from the electricity, gas and fibre networks.
28. In this respect, a propose/respond model provides an opportunity for Watercare to prepare proposed approaches to key regulatory accounting choices and regulatory processes to be submitted to the Commission for consideration and consultation. This would allow Watercare to contribute to the development of the artifacts which will contribute to determining the initial settings for PQ regulation.

29. Consistent with a propose/respond model, Watercare could develop a proposal document for the regulatory methods and initial settings which:
- 29.1. reflects Watercare’s relevant context and information;
 - 29.2. includes comprehensive options assessment against key criteria, such as the Part 4 purpose, FCM and sustainability and sufficiency objectives under the Local Government (Water Services) Act 2025 (**LGWS Act**);
 - 29.3. reflects expert input where appropriate;
 - 29.4. draws on regulatory precedent, including reasons for proposed departures from existing methods adopted in other regulated sectors; and
 - 29.5. includes detailed drafting of methods and approaches.
30. Watercare considers that adopting a propose/respond model whereby Watercare proposes the core regulatory settings for a BBM PQP (which must not have been previously determined without consultation) reduces the risk of de facto IMs being established without sufficient consideration of alternatives, proper consultation or expert input, and therefore better promotes regulatory certainty and predictability.
31. Alternatively, Watercare submits that, as a minimum, the proposed Position Paper process is amended and extended. It is critical that there is adequate consideration of Watercare’s most up to date information, alternative approaches and full consultation on regulatory accounting matters, before any decisions are made, separate to and in advance of any PQP draft decision.
32. In Watercare’s view, this alternative approach will reduce regulatory risk, improve the quality and credibility of early regulatory decisions for Watercare and the Commission, and better align Watercare’s PQ regulation with the statutory purpose of promoting the long-term benefit of consumers.
33. We encourage the Commission to consider the views we have presented in this submission in this respect, and we would welcome the opportunity to discuss how we can assist with option assessment and methodology development as this workstream proceeds.

Watercare’s concerns with proposed implementation of FCM

34. Watercare welcomes the Commission’s recognition that allowed revenues under PQ regulation should be set such that Watercare is able to meet Watercare’s financial sustainability and revenue and investment sufficiency obligations. However, Watercare is concerned about the way in which the Approach Paper indicates that this is to be implemented in practice.

Initial RAB value

35. The Approach Paper proposes that the means by which Watercare’s financial sustainability and revenue and investment sufficiency obligations should be met is through the setting of the initial RAB value. Whilst the Approach Paper does not explain how this would be implemented in practice, the Commission has since developed and published a proof-of-concept model that it proposes to use to determine an initial RAB value. Watercare understands that the initial RAB value would be adjusted up or down such that the resulting regulated cash flows (conditional on the forecasts and input assumptions adopted in the model) would produce a target free fund from operations (**FFO**) to net debt ratio and minimise the present value of notional building block revenues over a long-term forecast period.

36. Watercare has concerns with this approach because:
- 36.1. it is inherently circular and is not consistent with the principle of FCM, and may not allow for the recovery of the costs of historical investment in regulated infrastructure;
 - 36.2. it is sensitive to forecast assumptions adopted, and it is very difficult to forecast to the level of reliability required for the model, even over short horizons. Once the initial RAB is adopted, the forecasts are effectively locked in, and therefore may not produce outcomes which are consistent with investment sufficiency and financial sustainability over time;
 - 36.3. it assumes that regulated cash flows should be sufficient to meet Watercare's forecast actual debt obligations, rather than the debt obligations of a benchmark efficient business in Watercare's circumstances. This would be a departure from the standard approach to incentive-based PQ regulation; and
 - 36.4. it assumes all free cash flows are committed to new investment and, thereafter, to retiring existing debt. This means no cash flows are assumed to be retained by the business to buffer against unexpected shocks.
37. In addition, the current version of the model includes key assumptions and inputs which do not reflect Watercare's most up to date information and are not consistent with financial sustainability and investment sufficiency. These include:
- 37.1. unrealistic assumptions about long-term forecasts of capex and infrastructure growth charge (**IGC**) revenue;
 - 37.2. a target FFO/net debt ratio which is too low;
 - 37.3. a cost of contributed capital that is set equal to the cost of debt, with no cost of equity allowance; and
 - 37.4. oversimplified assumptions about remaining and standard asset lives, which have a significant impact on the value of the initial RAB produced by the model.
38. The assumption that all capex will be funded by debt removes Watercare's ability to efficiently manage its capital structure. It would require Watercare to operate extremely conservatively. The Commission would effectively be setting the capital structure and risk profile of the company.
39. Accordingly, Watercare does not support the Commission's proposed approach to setting the initial RAB value. It is highly dependent on assumptions and uncertain forecasts which under an FCM model cannot realistically be revisited in the future to address adverse consequences. It is not consistent with the FCM principle or promoting regulatory stability and certainty. For these reasons, Watercare is not confident that the proposed approach would in fact support Watercare's ability to meet its financial sustainability and revenue sufficiency obligations.

Cost of capital

40. The Approach Paper is silent on the proposed method for setting the cost of capital allowance for Watercare. In this respect we note that the Commission has developed a cost of capital method that is broadly consistent across the other sectors it regulates. That approach involves estimating a weighted average cost of capital (**WACC**) for the regulated industry, comprising benchmark

cost of debt and equity allowances, where the relative weights applied to the allowed cost of debt and cost of equity are determined by a benchmark gearing assumption.

41. Watercare notes that, by default, the proposed RAB model sets the return on notional contributed capital (i.e., equity) equal to the allowed cost of debt. That is, the model seems to be assuming that Watercare does not require a return on equity capital invested in its assets, and that equity capital only needs to be compensated for risk as though it was debt capital. While the Local Government (Auckland Council) Act 2009 (**LG Act**) prevents Watercare from paying dividends to and receiving equity from its shareholder, Auckland Council (**Council**), these provisions do not mean that Watercare does not require a return on equity capital invested.
42. The only way that Watercare can finance new investment is through new debt and/or accumulated retained earnings/surpluses. If the Commission provides Watercare with no cost of equity allowance, Watercare will be unable to accumulate surpluses that can be used to finance new investment and would therefore have to rely entirely on new debt. A sufficiently large investment programme could result in imprudently high gearing that could imperil Watercare's credit rating. Any surpluses retained in the business would ultimately benefit consumers because they will be retained to fund investment.
43. Accordingly, Watercare submits that the Commission should adopt a standard framework where it sets allowed revenues for Watercare using both an allowed cost of equity and debt with benchmark gearing assumptions. This is consistent with providing incentives for Watercare to fund investment prudently and efficiently in a way that promotes the Part 4 purpose. Conversely, an approach that assumes Watercare has no cost of equity will materially impair its ability to efficiently invest for the long-term benefit of consumers.

An alternative approach

44. Watercare proposes an alternative approach to implementing FCM and the core revenue building blocks to be used for Watercare's first and subsequent BBM-based PQPs. This would involve determining the initial RAB using historical cost information.
45. In Watercare's case, a deemed historical cost (**DHC**) valuation derived from historical records rolled forward using conventional RAB methods and audited asset information is particularly appropriate given the way the entity was established at the time Watercare first assumed responsibility for water and wastewater services for the Auckland region. Watercare was established in FY11 following the reorganisation of Auckland's local authorities, at which point the water and wastewater assets of the contributing councils were legally vested in Watercare. The value of those assets, and the transfer of associated liabilities, was formally approved through enabling legislation, which came into force on 1 November 2010.
46. Watercare considers this provides a clear and legislatively sanctioned reference point for establishing an initial DHC based RAB. It is more consistent with FCM and more principled than the modelled RAB approach which relies on, and is sensitive to, significant judgements and assumptions, not grounded in empirical evidence. It is not the case that the initial RAB value must be based on existing regulatory valuations.
47. Under a DHC approach, the initial RAB can be established from the integration date using the vesting values and rolled forward using standard regulatory methods. This will involve adding subsequent capital expenditure at cost, net of the value of vested assets and applying annual depreciation based on GAAP depreciation rates.
48. Our investigations suggest that it is possible to use Watercare's existing asset register and financial reporting information and to make the adjustments required to derive a DHC from

vesting date. The information available is also consistent with the granularity which supports the RAB roll forward process once the initial RAB is established.

49. Once the initial RAB has been determined on this basis, the Commission would set a revenue allowance for Watercare using a BBM framework in the same way it does for regulated electricity, gas and fibre networks. In doing so the Commission would:
 - 49.1. set a benchmark WACC allowance reflecting cost of debt and cost of equity allowances, benchmark capital structure and credit rating assumptions;
 - 49.2. set a depreciation allowance reflecting the remaining lives of Watercare's existing asset base and forecast capital additions and disposals; and
 - 49.3. adopt forecasts of prudent opex and capex, determined through the PQP propose/respond process.
50. The financial sustainability and revenue sufficiency obligations would be satisfied as follows:
 - 50.1. expected regulatory cash flows should be sufficient to support the benchmark credit rating at the benchmark level of gearing; and
 - 50.2. if necessary, the PQP should be adjusted to increase the regulated cash flows to achieve this.
51. A financeability test would be implemented by the Commission at each PQP determination to assess the sufficiency of the regulated cash flows. This test could be modelled on the test recently developed by the Commission for electricity distribution businesses (**EDBs**), and suitably adapted to the water sector by having regard to the rating methodologies applied by rating agencies such as Moody's when conducting rating assessments for regulated water utilities. There are several examples of water sector regulators in Australia, the UK and elsewhere conducting similar financeability tests when making PQP determinations.
52. We note that if the Commission were to apply an appropriate financeability test when making PQP determinations, and act when a financeability problem was identified, there should be no reason why the financial sustainability and revenue sufficiency obligations would not be met where the initial RAB was determined on the basis of DHC as we have proposed.

Other PQP decisions

53. Watercare also proposes:
 - 53.1. considering Watercare specific factors when determining the RAB roll forward method, including depreciation and indexation, inclusion of capex when incurred, or staged commissioning for significant projects, and alignment with GAAP rules to aid implementation;
 - 53.2. adopting a revenue cap with wash-up form of control, with core quality standards to be proposed by Watercare, supported by performance monitoring under ID regulation;
 - 53.3. taking a staged and proportionate approach to implementation of PQ regulation for Watercare which recognises that not all features of a fully developed regulatory regime need to be introduced in the first PQP determined under Part 4, such as financial incentive schemes;

- 53.4. adopting a three-year BBM PQP period initially, with longer periods in future once the regime matures and IMs are determined; and
 - 53.5. allowing reopeners and other uncertainty mechanisms to respond to unforeseen events, legislative change, financeability constraints and major projects that become more certain over time.
54. Watercare looks forward to working constructively with the Commission through the development and implementation of IMs and PQ regulation for Watercare and welcomes the opportunity to assist in the transition of the water sector into enduring economic regulation under the Commerce Act.

3. INTRODUCTION

55. This submission provides Watercare’s views on the Commission’s proposed approach for setting Watercare’s PQP under the Commerce Act.
56. Watercare supports the introduction of a robust, durable and predictable economic regulatory regime for the water sector and is committed to working constructively with the Commission to put in place enduring PQ regulation. Watercare considers that well-designed economic regulation can promote transparency, accountability and long-term benefit of consumers, while supporting the efficient delivery of essential water and wastewater services.
57. Watercare also recognises the importance of delivering services that meet the needs of end-users and other stakeholders. Service quality is fundamental to consumer trust and confidence, particularly in the context of essential services. Service quality was also at the heart of the desired outcomes of the Water Services Reform. Watercare is therefore dedicated to ensuring that service quality outcomes reflect consumer expectations and comply with relevant public health, environmental and planning obligations. Economic regulation should reinforce incentives to maintain and improve service quality over time.
58. The Approach Paper properly highlights the importance of ensuring that Watercare’s investments are sufficient to meet appropriate service levels and relevant regulatory obligations, while also driving ongoing efficiency improvements.² Watercare agrees that investment sufficiency and cost efficiency are central to promoting the long-term benefit of consumers. In the context of long-lived water infrastructure, regulatory settings must support timely investment in renewal, growth and resilience to avoid the higher long-term costs associated with asset degradation or emergency interventions.
59. Watercare also considers it is important that its revenues under the PQP should be sufficient to support required investment and that it is able to meet its debt covenants and maintain prudent long-term financial sustainability. Revenue sufficiency and financeability are not ends in themselves, but necessary conditions for delivering reliable, resilient and affordable services to consumers over time. Regulatory settings that do not adequately account for financeability risks can ultimately result in higher costs or service disruptions for consumers.
60. In this respect Watercare interprets these key objectives as follows:
- 60.1. Investment sufficiency – Watercare is able to make necessary and prudent investments and efficiently access the capital required to do that.
 - 60.2. Revenue sufficiency – consistent with the FCM principle, Watercare is able to recover prudent and efficient costs, including a reasonable return on investment, incurred when delivering the regulated services.
 - 60.3. Financial sustainability – Watercare is able to maintain an investment grade credit rating, primarily measured through FFO/net debt and gearing.

² Approach Paper, para 2.4

4. STATUTORY PROVISIONS FOR ECONOMIC REGULATION

The s52A Purpose Statement

61. Section 52A of the Commerce Act sets out the overarching purpose of Part 4 regulation:
- to promote the long-term benefit of consumers in markets where there is little or no competition by promoting outcomes that are consistent with those produced in competitive markets*
62. These outcomes include ensuring that regulated suppliers:
- a) *have incentives to innovate and invest, including in replacement, upgraded and new assets;*
 - b) *have incentives to improve efficiency and provide services at a quality that reflects consumer demands;*
 - c) *share with consumers the benefits of efficiency gains over time; and*
 - d) *are limited in their ability to extract excessive profits.*
63. Watercare agrees with the Approach Paper that section 52A must be the primary lens through which the PQP is designed and implemented.³ In the context of essential water and wastewater services, promoting the long-term benefit of consumers requires particular emphasis on investment sufficiency, service resilience and intergenerational equity, given the long-lived nature of assets and the asymmetric harm to consumers from under-investment.
64. Watercare notes that section 52A does not require the Commission to pursue short-term price minimisation or mechanistic outcomes. Rather, it requires regulatory decisions to be assessed against their long-term effects on consumers, including the durability and credibility of the regulatory framework itself.

The purpose of IMs

65. In other regulated sectors, IMs play a central role in giving effect to the section 52A purpose. IMs establish the rules, requirements and processes that underpin both PQ and ID regulation, including methodologies for asset valuation, cost of capital, cost allocation, and key regulatory processes.
66. By setting these methodologies upfront, IMs:
- 66.1. promote regulatory certainty, predictability and transparency;
 - 66.2. reduce the scope for *ad hoc* or inconsistent decision-making;
 - 66.3. enable regulated suppliers to prepare PQP proposals with confidence; and
 - 66.4. provide stakeholders with clarity on how regulatory decisions will be made and assessed.

³ Approach Paper, para 2.2

Challenges arising in the absence of IMs

67. While the Commerce Act provides the Commission with discretion not to set IMs for water services prior to the first PQP, seeking to apply FCM without IMs creates legal and practical challenges. Without IMs:
- 67.1. foundational regulatory choices would be made without the statutory safeguards that normally apply,⁴ including enhanced consultation and merits appeal rights;
 - 67.2. there is increased risk that ‘indicative’ positions function as de facto methodologies without formal status, and may become entrenched within the framework without a clear process for their review over time;
 - 67.3. regulated suppliers face uncertainty about the criteria and assumptions that will ultimately be applied to their PQP proposals; and
 - 67.4. rating agencies and lenders face uncertainty about Watercare’s ability to manage debt and maintain an investment grade credit rating.
68. These challenges are especially acute where the decisions in question — such as the initial RAB, cost of capital and regulatory accounting framework — have enduring effects beyond the first regulatory period.

How the regime plays out over time

69. The Approach Paper indicates that the Commission views the first PQP as part of a longer-term regulatory journey, with the potential for methodologies and approaches to evolve as experience is gained.⁵
70. Watercare acknowledges the Commission’s intention to retain flexibility and to learn from the initial application of PQ regulation to water services. However, it considers that this creates an inherent tension. Decisions taken for the first PQP are described as transitional, yet are likely to materially influence future PQPs and may form the basis of future IMs.
71. This raises important questions about:
- 71.1. how tightly future PQPs will be aligned to the first PQP determination;
 - 71.2. how open the Commission will be to adopting new approaches once foundational decisions are embedded; and
 - 71.3. whether early decisions, such as the initial RAB, can realistically be revisited and any adverse consequences resolved, and whether this can be achieved without creating regulatory instability and uncertainty.

Setting upfront IMs promotes the regulatory purpose

72. While acknowledging that the Commerce Act permits the establishment of Watercare’s first PQP without first determining IMs, the Commission is not prevented from setting upfront IMs. Furthermore, the ability not to set IMs for water services does not give the Commission the ability to set the initial rules and processes (whether IMs or not) without following a proper process.

⁴ Under Part 4 of the Commerce Act and Part 6 of the Telecommunications Act

⁵ Approach Paper, para 1.23

73. In our view, the establishment of upfront IMs (through the prescribed statutory process) would be most effective at promoting the Part 4 purpose statement and regulatory certainty, if a BBM approach to determining maximum revenues consistent with FCM, is to be adopted. This is because, while the concept of FCM is relatively uncontentious, the long-term benefits of the FCM principle to consumers is highly contingent on how well it is implemented in practice.
74. IMs were designed as a mechanism to allow different views to be fully tested upfront, before regulation was applied. This approach was taken by the Commission when first implementing PQ regulation for electricity, gas and fibre networks, and ID regulation for airports and the other regulated sectors.
75. In this respect we note that the Approach Paper provides little information on core FCM building blocks (e.g., the initial RAB⁶ and cost of capital), but indicates that further information will be made available in mid-2026 in a Position Paper on regulatory accounting.
76. Critically, there is to be no opportunity for Watercare or other stakeholders to provide feedback on the Position Paper under the currently proposed process. The first opportunity for input into the core regulatory accounting decisions, including RAB and cost of capital, will only occur once the Commission has determined its draft decision on Watercare's PQP, which is due early 2028. At that point there will be very little time to consider alternative approaches and additional evidence and modify the draft decision. Watercare is concerned that this will result in the methodologies that will be adopted by the Commission as core inputs to the PQP being foregone conclusions, with little input from Watercare or other stakeholders. Such an outcome would be in sharp contradiction to the way PQ regulation has been introduced to other sectors in New Zealand.
77. The Approach Paper proposes a BBM approach to Watercare's first PQP and effectively proposes to set *de facto* IMs without following the formal IM process. These decisions could pre-determine the outcome of future IM determinations.
78. We therefore submit that in implementing a BBM approach consistent with the FCM principle in line with other regulated sectors, the Commission should determine upfront IMs to provide greater regulatory certainty. This will provide better confidence that FCM will be implemented in a manner consistent with the Part 4 purpose statement.
79. Even if there are no upfront IMs, it remains critical that Watercare and other stakeholders have an opportunity to contribute to and comment meaningfully on the development of the core regulatory accounting decisions to be addressed in the Position Paper prior to the draft decision.
80. We acknowledge that determining IMs takes time,⁷ however Clause 31 of Part 6 of Schedule 1AA of the Commerce Act provides for an extension of the first regulatory period that applies under the Local Government (Preliminary Arrangements) Act 2024 (**Preliminary Arrangements Act**) (effectively, the Charter period. Watercare proposes that such an extension (and an extension of adjusted PQ settings under the Charter) would provide an appropriate transitional framework while IMs are established.
81. An extension of the first regulatory period would also provide more time for Watercare to prepare its PQP proposal, and the Commission with an opportunity to properly resource the development of a robust and considered framework for PQ regulation, as discussed in the following section.

⁶ After the publication of the Approach Paper, on 18 December 2025, the Commission released a 'proof-of-concept' model to support its proposed modelled RAB approach to the initial RAB for Watercare.

⁷ Between one and two years, based on regulatory precedent.

5. PROCESS FOR SETTING WATERCARE'S PQP

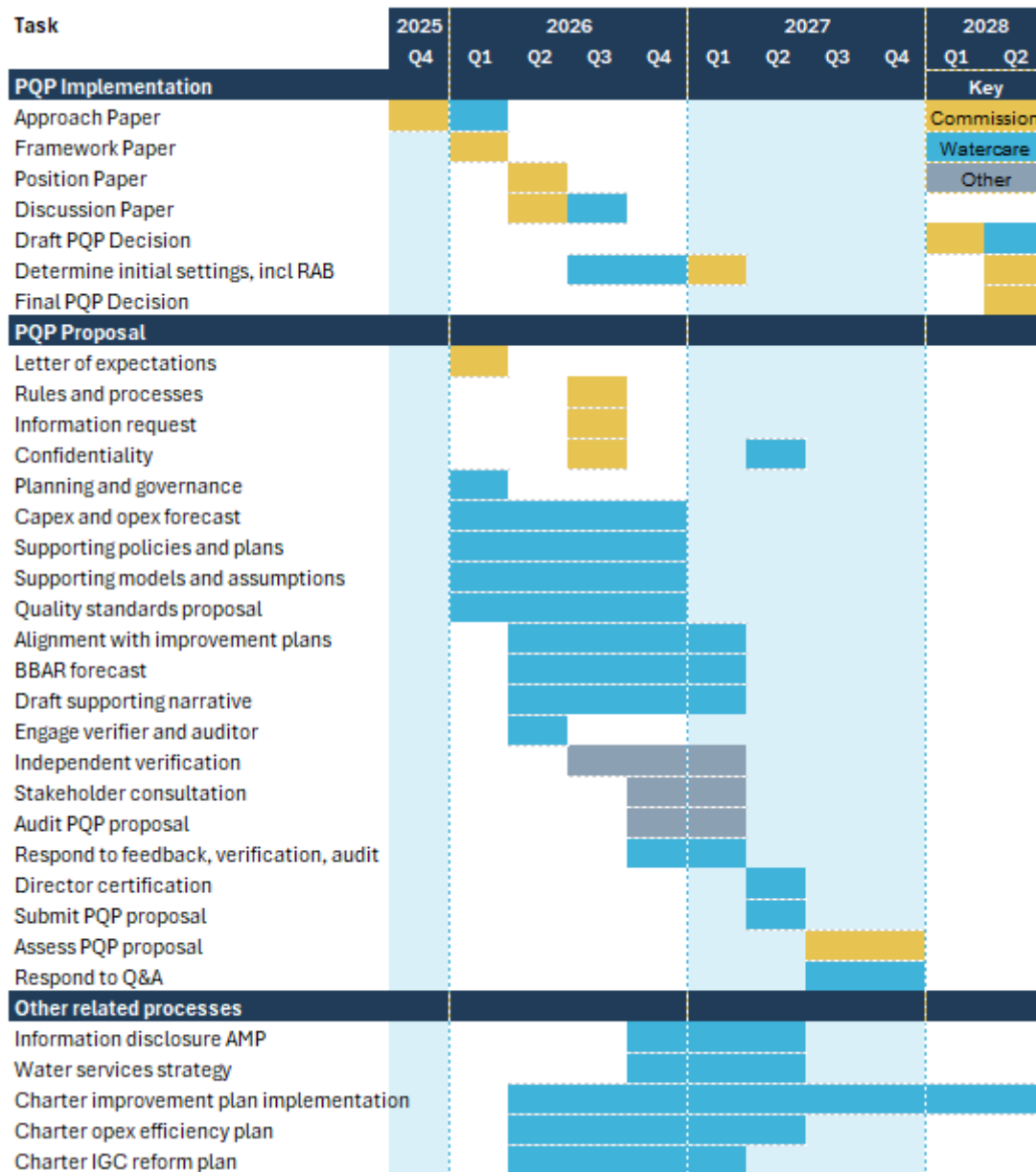
Proposed process

82. Watercare supports the objective of providing early visibility on the intended approach to setting Watercare's PQP. The Approach Paper sets out a process and approach which is similar to the individual price-quality path (IPP) propose/respond processes which currently apply to Transpower and Chorus. However, given the Charter period currently ends on 30 June 2028, and therefore Watercare's PQP is currently required from 1 July 2028, there is less time available to prepare Watercare's PQP proposal than is normally available to Chorus and Transpower.
83. As noted above, the proposed compressed timetable is complicated by the fact that IMs have not yet been determined. Experience of other regulated sectors demonstrates that the development of a robust PQ proposal typically follows the establishment of IMs and involves a multi-year preparatory phase. The entities in other regulated sectors benefited from settled rules on asset valuation, cost of capital, and regulatory processes before being required to submit expenditure and quality proposals subject to external scrutiny and independent verification.
84. Watercare is being asked to develop its first PQP proposal in the absence of these foundations and within a significantly shorter timeframe.
85. Watercare considers that this approach materially increases the risk that the first PQP will be based on incomplete information, untested assumptions and provisional methodologies, with adverse consequences for long-term consumer outcomes. There is a real risk that initial settings, such as the initial RAB, will not be able to be unwound, if they prove in the future to be inconsistent with the regulatory purpose and the objectives of the LGWS Act.
86. To the extent there is any risk that extending the first regulatory period and the price-quality settings under the Charter could result in sub-optimal outcomes by deferring implementation of a BBM method, Watercare believes that any such short term deficiency will nevertheless better promote the long term benefit of consumers in comparison to the current proposal, which risks implementing enduring material regulatory deficiencies.
87. Accordingly, we submit that modifications to the timeline are required to ensure that Watercare's PQP is based on robust information and that sufficient time is available to complete fundamental regulatory processes and decisions with appropriate scrutiny and deliberation.

Proposed timeline

88. The figure below is a summary view of the key tasks to be completed prior to 1 July 2028, when Watercare's PQP will currently come into effect. The timelines are indicative, and in some instances are likely to be unworkable, because of sequencing issues which we discuss further below.

Figure 1 - Proposed timeline for PQP implementation



PQP proposal development and decision-making on rules and processes

- 89. Watercare is particularly concerned about the proposed sequencing outline above, which envisages that key regulatory accounting and financial framework decisions will be progressed through position papers and internal modelling exercises, with limited or no opportunity for formal submissions. Key examples include:
 - 89.1. the proposed Position Paper, which is intended to articulate likely building block choices without consultation;
 - 89.2. the development of a modelled initial RAB, involving significant judgement and long-term consequences and a change of approach from other sectors; and
 - 89.3. the absence of clarity on the intended approach to determining the cost of capital.

90. In addition, the timeline requires Watercare to make substantial progress on its PQP proposal in the first half of 2026, which is before the planned consultation on PQP choices, such as expenditure forecasts and incentives, quality standards and performance requirements, and other PQP design and implementation decisions.
91. Without clarity on core components of the regulatory framework, Watercare cannot reliably assess consumer impacts of alternative expenditure paths or service levels, nor can we robustly test the financeability and sustainability of alternative revenue limits.
92. These core components include the criteria against which expenditure and quality proposals will be evaluated, and the basis for establishing the regulatory cost base.
93. Proceeding to a full propose/respond process in these circumstances risks inefficient use of regulatory and stakeholder resources and increases the likelihood that the first PQP will require material revision late in the proposal and approval process, once foundational settings are settled.

Other parallel regulatory workstreams

94. There is a significant workload for Watercare to undertake in developing its first PQP proposal at the same time as transitioning to economic regulation and completing related programmes of work. Other regulatory workstreams will also run in parallel with preparation of Watercare's PQP proposal over the forthcoming months.
95. Significant deliverables over and above the PQP proposal for verifier review by Q3 2026 include:
 - 95.1. completion and implementation of improvement plans required under the Charter, including the Infrastructure Delivery and asset management plan (**AMP**), the Operating Cost Efficiency Plan and the IGC Reform Plan;
 - 95.2. preparation of the initial ID AMP, strategic AMP (**SAMP**) and infrastructure delivery plan (**IDP**) to be issued by Q2 2027, noting that the PQP proposal and the AMP will need to be internally consistent; and
 - 95.3. preparation of Watercare's first Water Services Strategy (**WSS**) required under the LGWS Act, by Q2 2026.

Ongoing implementation of Charter improvement initiatives

96. Watercare is now at a key point in its asset management journey, as it is embarking on implementation of its Infrastructure Delivery and Asset Management Improvement Plan released in January 2026, developed under the Charter. This will drive flow-on changes to our policies, processes, and approach to expenditure planning and forecasting.
97. As part of producing this plan, external consultants and an independent verifier conducted current state assessments of Watercare's infrastructure delivery and asset management maturity. This process identified improvement opportunities, including for a review of Watercare's business case standardisation framework, integrated asset data systems and a benefits management approach.
98. Watercare also continues to work on its Operating Cost Efficiency Improvement Plan. It provided the Commission with a draft of this plan at the end of 2025, to be finalised once feedback is received. Work is also ongoing on Watercare's IGC Reform Plan.

99. Generating a BBM PQP proposal on current timeframes requires us to produce forecasts and proposal rationale from Q2 2026 based on current information and categories, prior to improved policies, processes and documentation being developed under these plans. While this may be possible, it means that forecasts of capex and opex will need to be justified without the benefits of these new processes, and with information gaps. Assessment of proposals will be less straight forward and will need to be managed proportionately to reflect Watercare’s status, and balance implementation of the Part 4 purpose against Watercare’s current operational maturity. This will likely mean that benefits driven for consumers by the Charter would not have a material impact on the first PQP settings under Part 4 of the Commerce Act, which are required to be in place for a minimum of three years.

ID and PQ sequencing

100. The draft ID decision for water entities was released in September 2025.⁸ This included more onerous SAMP, AMP and IDP requirements than are included within Watercare’s current asset management governance documents. Under the draft decision, initial disclosure dates are June 2027. Final ID decisions are expected at the end of February 2026.
101. Development of a SAMP, AMP and IDP which meet ID requirements is expected to bring further benefits for consumers. However, it will be a resource-intensive process, requiring input from the same resources needed to prepare Watercare’s PQP proposal.
102. In other sectors, requirements for updated asset management documentation were phased around PQ processes. Indeed, Chorus is still to be required to produce an updated AMP under the Part 6 regime for fibre.
103. Requiring Watercare to produce both a PQP proposal and ID AMP documentation at the same time will limit the focus which can be applied to each and further risks the quality of Watercare’s first PQP proposal.

Water services strategy

104. In addition to other inter-linkages, Watercare is required to include the following in its WSS under the LGWS Act:

a statement of the provider’s intended levels of service provision, which must include—

(i) the performance measures that apply to the group of water services activities, including as applicable—

A. the measures that the water service provider considers will enable the public to assess the level of service for major aspects of the group of water services activities; and

B. any intended levels of service that the water service provider is required to publicly disclose in a water services strategy in accordance with a section 52P determination under the Commerce Act 1986; and

C. if no similar requirements have been set under sub paragraph B, any performance measures specified in a rule made under section 261B of the LGA 2002 that are relevant to a group of water services activities; and

⁸ Economic Regulation of Water Services – Information Disclosure, draft decision package, 11 September 2025

(ii) the performance targets for each performance measure under subparagraph (i); and

(iii) any relevant quality standards or performance requirements in a section 52P determination under the Commerce Act 1986;⁹

105. This means that, even while there is no s52P PQP determination in place, Watercare is required to disclose substantially similar information to a PQP proposal, including intended levels of service. The WSS responds to a Statement of Expectations (**SOE**) from the Council, which may include performance indicators and measures that the Council may use to monitor Watercare¹⁰. Council's first SOE for Watercare must be delivered by the end of 2026 (and could be earlier), however further information on the regulatory requirements for quality standards is not expected until Q2 or Q3 2026 with the release of a discussion paper to consult on 'other' PQP design choices (**Discussion Paper**) and subsequent consultations.
106. While Watercare can base its PQP proposal under Part 4 on separately proposed quality standards, there is a risk that the PQP proposal and the WSS will be published in parallel but reflect different approaches to quality standards and performance measurement. This outcome would be suboptimal for Watercare's consumers and add undue regulatory complexity for our compliance and performance obligations.
107. Establishing quality standards that align with consumer expectations is an important benefit of PQ regulation, particularly where price-quality trade-offs exist. Consideration needs to be given to how this is achieved alongside other existing processes and obligations on Watercare.
108. Phasing this work around development of Watercare's initial WSS would again allow Watercare to sequence work in a more effective order, whilst preserving our ability to flow learnings through to the WSS in the future once a s52P determination was determined, as envisaged by legislation.

Proposed alternative timing

109. Watercare submits that there are credible and practical alternative approaches available that would provide more durable, evidence-based outcomes than the current timetable allows, and which will better promote regulatory certainty, consistent with promoting the long-term benefit of consumers.
110. Watercare proposes that the PQP first regulatory period under the Preliminary Arrangements Act is extended for a period of up to two years to provide more time before setting Watercare's first PQP under Part 4. This could be based on extending the PQ settings under the Charter with an appropriate growth rate, subject to price shock and financeability cross checks, and with similar compliance reporting for price-setting and performance outcomes.
111. Adopting an extension (with adjustments) of the Charter PQ regulation framework would provide the Commission with the opportunity to properly resource the development of the framework, and to prepare for PQ regulation.
112. It would also enable Watercare to focus efforts on development of AMPs before embarking on development of a PQP proposal. In addition, providing further time would also enable key rules and processes to be determined; while allowing for continued PQ oversight of Watercare's transition to permanent economic regulation.

⁹ LGWS Act, Schedule 3, clause 3(1)(c)

¹⁰ LGWS Act, s227(2)(b)

113. Thus, a delay of up to two years before adopting a PQP under Part 4 would provide sufficient time for:
- 113.1. Watercare to prepare a more robust BBM PQP proposal, reflecting feedback from independent verification, consultation and audit processes and requirements on the Commission to assess the proposal (which is very challenging under the existing proposed timeline);
 - 113.2. Watercare and the Commission to establish foundational regulatory settings including initial regulatory accounting information and building block revenue forecasts;
 - 113.3. Watercare to align PQP proposal inputs with other plans and regulatory processes including in relation to ID regulation and the Charter; and
 - 113.4. Watercare and the Commission to reflect more of the improvement plans, learnings and initiatives which are emerging under the Charter in the PQP proposal and decision. We expect these learnings to enable Watercare to deliver a more optimised expenditure planning approach, with appropriate prioritisation and phasing to ensure the plan is delivered and our target service outcomes are met.
114. In the absence of further time for preparation of a PQP proposal, Watercare would need to generate expenditure proposals based on current forecasts and support them with current-generation asset management documentation. This would likely require us to consider requesting an exemption for requirements that our first ID SAMP / AMP / IDP was published by 30 June 2027, if this continues to be the requirement as part of the final ID decision.
115. A transitional extension of the Charter for up to two years would also provide more time and a greater opportunity for proper consultation on how FCM should be implemented before setting Watercare's first PQP under Part 4 of the Commerce Act, using a propose/respond model.
116. Even if formal upfront IMs are not set, it is critical that Watercare and other stakeholders have an opportunity to contribute to and comment on the development of the core regulatory inputs and accounting decisions – currently proposed to be addressed in the Position Paper prior to the draft decision.
117. Ideally upfront methods would be determined for all key regulatory inputs, drawing on well-established precedent, including for cost allocation, asset valuation, cost of capital, form of control and regulatory processes such as reopeners and PQP proposal matters. We recommend that the approach adopted to these matters is informed by the existing IMs and the learnings from the electricity, gas and fibre networks.
118. In this respect, a propose/respond model provides an opportunity for Watercare to prepare proposed approaches to key regulatory accounting choices and regulatory processes to be submitted to the Commission for consideration and consultation. This would allow Watercare to contribute to the development of the artifacts which will contribute to determining the initial settings for PQ regulation.
119. Consistent with a propose/respond model, Watercare could develop a proposal document for the regulatory methods and initial settings which:
- 119.1. reflects Watercare's relevant context and information;
 - 119.2. includes comprehensive options assessment against key criteria, such as the Part 4 purpose, FCM and LGWS Act sustainability and sufficiency objectives;

- 119.3. reflects expert input where appropriate;
 - 119.4. draws on regulatory precedent, including reasons for proposed departures from existing methods adopted in other sectors; and
 - 119.5. includes detailed drafting of methods and approaches.
- 120. Watercare considers that adopting a propose/respond model whereby Watercare proposes core regulatory settings for a BBM (which must not have been previously determined without consultation) reduces the risk of *de facto* IMs being established without sufficient consideration of alternatives, consultation and expert input, and therefore better promotes regulatory certainty and predictability.
 - 121. Alternatively, Watercare submits that, as a minimum, the proposed Position Paper process is amended and extended. It is critical that there is adequate consideration of Watercare's most up to date information, alternative approaches and full consultation on regulatory accounting matters, before any decisions are made, separate to and in advance of any PQP draft decision.
 - 122. In Watercare's view, this alternative approach will reduce regulatory risk, improve the quality and credibility of early regulatory decisions for Watercare and the Commission, and better align Watercare's PQ regulation with the statutory purpose of promoting the long-term benefit of consumers.
 - 123. To maximise this opportunity, it is necessary to make this decision as soon as possible, as under the current timetable, Watercare must make substantial progress on its PQP proposal in the first two quarters of 2026.

6. REVENUE BUILDING BLOCKS AND FINANCIAL CAPITAL MAINTENANCE

FCM and revenue building blocks supported in principle

- 124. Watercare supports the Commission's preliminary view that a building blocks approach underpinned by FCM is an appropriate and well-established framework for enduring PQ regulation.
- 125. This approach has strong regulatory precedent in New Zealand (e.g., electricity, gas and fibre networks) and internationally, particularly for utilities characterised by natural monopoly conditions, long-lived assets and essential service provision.
- 126. Watercare considers that an FCM-based framework is broadly consistent with the purpose in section 52A of the Commerce Act. In particular, it:
 - 126.1. promotes incentives to invest prudently and efficiently in replacement, upgraded and new assets (s52A(1)(a)); and
 - 126.2. limits the ability of suppliers to extract excessive profits (s52A(1)(d)).
- 127. When implemented appropriately, an FCM-based building blocks framework provides regulated suppliers with an opportunity to recover the prudent and efficient costs incurred in providing regulated services. It provides for:
 - 127.1. recovery of capital already invested through depreciation (return of capital); and

- 127.2. a return on capital commensurate with risk associated with delivering the regulated services (return on capital).
128. The FCM model supports access to capital markets and the financing of large, long-lived infrastructure assets that deliver services over time to multiple generations of consumers.
129. It also provides a transparent and predictable framework for setting user charges over time. By anchoring revenues to an asset base that is rolled forward according to defined rules, it promotes regulatory certainty and supports efficient investment planning. This is particularly important for water and wastewater services, where assets often have lives measured in decades and investment decisions are largely irreversible.

Dependence on implementation choices

130. However, whether FCM delivers outcomes consistent with funding needs, affordability and long-term financial sustainability depends critically on how the framework is implemented and maintained over time. The specification of foundational building blocks — particularly the initial RAB, cost of capital, depreciation methods and roll-forward rules — materially influences funding profiles, cash flows and pricing trajectories across regulatory periods.
131. Adopting FCM represents a substantive transition from the current Charter framework, which was designed as an interim regime focused on near-term cashflow sufficiency and financeability. This transition will affect funding, investment, pricing and cash flow profiles and therefore requires careful management as Watercare transitions to a FCM based BBM.
132. In Watercare’s view, the development of enduring IMs is ultimately the most effective way to ensure that FCM principles are applied consistently, transparently and durably. In their absence, there is an increased risk that FCM is applied inconsistently and/or unpredictably in a way that undermines regulatory certainty and long-term consumer outcomes.

Key building blocks insufficiently specified

133. While Watercare supports the Commission’s proposed direction of travel, the Approach Paper provides limited information on how FCM will apply in practice to Watercare, both in the first PQP and over the longer term. This lack of detail is particularly problematic given the foundational role of these decisions.
134. Under an FCM framework, the most significant regulatory building blocks are asset valuation (including the initial RAB and the RAB roll forward method) and the cost of capital. However, the Approach Paper is largely silent on how these inputs will be established in practice, what criteria and judgements will be applied; and how consistency across building blocks will be ensured.
135. Watercare acknowledges that subsequent material released by the Commission on the proposed modelled RAB approach has provided additional insights and informed this submission. However, the judgements and assumptions proposed in that model have only strengthened Watercare’s reservations about the approach being proposed, as the indicative approach to establishing an initial RAB value in that model represents a departure from the approach applied to other regulated industries in New Zealand. There are no characteristics peculiar to Watercare or the water sector that justify such material and unexpected departures, and such material departures from established approaches create significant uncertainty and unpredictability around the regulatory framework.

136. Watercare is also concerned that the proposed Position Paper, which we understand will provide more information on the proposed approach to the foundational building blocks, is intended to be progressed without a formal opportunity for submissions.
137. Not only is this not consistent with good regulatory practice, where significant decisions are being contemplated, there is still a statutory requirement to consult on s52P determinations (even if IMs are not set).¹¹ There is a real risk that *de facto* draft decisions are made without consultation, appropriate expert challenge, based on judgements which are not grounded in evidence, or information about Watercare that is not complete, robust or fit for purpose. For this reason, we propose that key IMs are determined upfront, before a PQP is determined for Watercare under Part 4.

7. INITIAL RAB AND FINANCEABILITY

Financeability

138. The Approach Paper states the following:

Our approach to setting a price-quality path is guided by the Part 4 purpose, and other relevant provisions of the Act. We must also take into account Watercare's obligations under other legislation, which include financial principles relating to investment sufficiency, revenue sufficiency and financial sustainability.¹²

139. As the Approach Paper explains, the financial principles referred to by the Commission are those codified in the LGWS Act and the Charter.

140. Section 18(b) of the LGWS Act provides that:

the provider must ensure that the revenue and funding it applies to providing water services is sufficient to sustain the provider's long-term investment in its water services while meeting all regulatory requirements.

141. The Approach Paper references this legal obligation on Watercare at paragraph 2.5.2.

142. Section 13(1) of the Charter requires that:

Watercare must ensure that its credit rating is at least investment grade.

143. The Approach Paper recognises this obligation and explains that Watercare's allowed revenues under price-quality regulation should allow Watercare to satisfy this requirement:

We consider Watercare's revenues under the PQP should be sufficient, but no higher than necessary, to satisfy long-term investment sufficiency and financial sustainability. Consistent with the Charter, revenue limits should also be consistent with Watercare maintaining at least an investment grade credit rating.¹³

144. Watercare welcomes the Commission's recognition that allowed revenues under PQ regulation should be set such that Watercare is able to meet the financial sustainability and revenue sufficiency obligations in the LGWS Act and the Charter. However, Watercare is concerned about the way in which the Commission is proposing to implement this in practice.

¹¹ In accordance with clause 35 of Schedule 7 of the Commerce Act.

¹² Approach Paper, para X5

¹³ Approach Paper, para 2.19

The Commission's proposal to set the initial RAB as a means of satisfying the financial sustainability and revenue sufficiency obligations

145. The Approach Paper proposes that the means by which Watercare's financial sustainability and revenue sufficiency obligations should be met is through setting the initial RAB value:

...we consider that Watercare's revenues under the PQP should be no higher than necessary to satisfy long-term investment sufficiency and financial sustainability.

Therefore, the initial RAB should be set at a value that, once input to the BBM, results in revenue that is high enough to cover Watercare's cashflow needs for its capital programme and general operations, and is consistent with Watercare maintaining an investment grade credit rating, but not so high that it gives rise to excessive returns.¹⁴

146. Whilst the Approach Paper does not explain how this would be implemented in practice, the Commission has developed and published a proof-of-concept model that it proposes to use to determine an initial RAB value.¹⁵ The model forecasts regulated cash flows for Watercare over a long-term horizon (up to 50 years) using a BBM framework. In doing so, the model:
- 146.1. adopts published Watercare financial forecasts (e.g., IGC revenue, cash and operating leases, operating expenditure, capital expenditure, closing debt balance in FY28); and
 - 146.2. allows for assumptions to be made about other key BBM inputs, including the rate of inflation, the cost of debt, the cost of notional contributed capital, the average remaining life of assets in 2029, the weighted average life of new assets and IGCs, and an initial RAB value.
147. Based on discussions with the Commission, Watercare understands that the initial RAB value would be adjusted up or down such that the resulting regulated cash flows (conditional on the forecasts and input assumptions adopted in the model) produced an FFO/Net debt ratio consistent with an assumed target, and to minimise the present value of notional building block revenues over a long-term forecast period.
148. The target FFO/Net debt ratio is currently set at 10% which aligns to the lower bound of Moody's broad BBB rating band for regulated water utilities.
149. In other words, the model solves for an initial RAB value that would, in expectation, produce a set of regulated cash flows consistent with a bare investment grade (i.e., BBB-) credit rating.
150. Watercare has several concerns with this proposed approach because:
- 150.1. It is inherently circular and therefore inconsistent with the FCM principle because it may fail to allow recovery of the cost of historical investments made by Watercare in its RAB prior to the commencement of PQ regulation.
 - 150.2. The initial RAB value is sensitive to the forecasts adopted in the model. Some of these inputs (e.g., IGC revenue¹⁶) are very difficult to forecast reliably even over relatively short horizons. In practice, forecasts of key inputs including IGCs and capex are

¹⁴ Approach Paper, para 4.31 and 4.32

¹⁵ <https://www.comcom.govt.nz/regulated-industries/projects/price-quality-path-for-watercare/>

¹⁶ IGC revenue is difficult to forecast as it reflects customer development activity and economic cycles, and although it is a source of funding for capital growth projects, it does not directly follow that changes in IGC revenue are matched by changes in growth capex.

revised over time as commercial market conditions and local planning rules change.¹⁷ Yet, the model assumes (for the purposes of determining an initial asset value) that these forecasts are ‘set in stone’ over the period for which they are available. Consequently, the forecasts used to determine Watercare’s initial RAB (which will determine its allowed revenues for decades to come) will almost certainly be superseded over time, become redundant and are unreliable beyond the current forecasting horizon.

- 150.3. This calls into question the assumption that the opening RAB set using its proposed model would result in “*revenue that is high enough to cover Watercare’s cashflow needs for its capital programme and general operations, and [would be] consistent with Watercare maintaining an investment grade credit rating.*”¹⁸
- 150.4. It assumes that regulated cash flows should be sufficient to meet Watercare’s forecast actual debt obligations, rather than the debt obligations of a benchmark efficient business in Watercare’s circumstances. In other words, the proposed approach does not appear to involve determining a benchmark capital structure. This would be a departure from the standard approach to incentive-based PQ regulation, including that developed by the Commission over nearly two decades for electricity, gas and fibre networks.
- 150.5. It assumes all free cash flows are committed to new investment and, thereafter, to retire existing debt. This means no cash flows are assumed to be retained by the business to buffer against unexpected shocks. No prudent business would operate in such a fashion, particularly if the business had no recourse to financial support from its shareholder, with the only source of external finance being additional debt (as is the case for Watercare).
151. The assumption that all capex will be funded by debt removes Watercare’s ability to efficiently manage its capital structure. It would require Watercare to operate extremely conservatively. The Commission would effectively be setting the capital structure and risk profile of the company.
152. In addition, the current version of the model includes key assumptions and inputs which do not reflect Watercare’s most up to date information and are not consistent with financial sustainability and investment sufficiency, including:
 - 152.1. The model forecasts capital expenditure and IGC revenue beyond the forecast period for which they are available, by applying unrealistic growth assumptions (e.g., growth in line with CPI inflation).
 - 152.2. It targets too low an FFO/Net debt ratio. As noted above, an FFO/Net debt ratio of 10% is consistent with the lower bound of Moody’s broad BBB/Baa rating band and is therefore commensurate with the FFO/Net debt ratio of a regulated water business with a BBB-/Baa3 credit rating. By contrast, most regulators of water businesses in Australia adopt a benchmark credit rating assumption of BBB/Baa2,¹⁹ and Ofwat (the former water sector regulator in England & Wales) adopted a benchmark credit rating

¹⁷ It will be necessary to have regard to development levy reform when specifying Watercare’s revenue building blocks. This is currently being consulted on by DIA under the Local Government (Infrastructure Funding) Amendment Bill.

¹⁸ Approach Paper, para 4.32

¹⁹ See, for example, QCA, Rate of return review, September 2024, Table 5, p. 43. https://www.qca.org.au/wp-content/uploads/2024/09/qca_rate-of-return-review_report_version-4_september-2024.pdf

assumption of BBB+/Baa1.²⁰ Moody's considers that an FFO/Net debt ratio of 10% to 15% is consistent with a broad Baa1 rating band.²¹ By interpolation, a credit rating of BBB/Baa2 would require an FFO/Net debt ratio of close to 12%.

- 152.3. It seems to assume that the cost of debt and cost of notional contributed capital is the same. Watercare would be very concerned if the Commission's assumption was that Watercare requires no return on equity capital, or that the required return on equity capital was equivalent to the cost of debt. Such assumptions would be entirely inconsistent with the approach to the cost of capital adopted by the Commission when applying PQ regulation to electricity, gas, and fibre networks. This approach could also create financeability problems for Watercare. As explained above, Watercare's shareholder is prohibited by law from providing any financial support or equity capital to Watercare. This means that Watercare may only use new debt and/or retained earnings/surpluses to finance future (non-growth) capital expenditure. If Watercare received no cost of equity allowance, it would be unable to generate the accumulated surpluses required to finance new investment. This, in turn, would require Watercare to rely exclusively on debt to finance future capital expenditure. A sufficiently large investment programme could result in Watercare gearing up to levels that could undermine its financial sustainability.
- 152.4. It adopts an oversimplified assumption about remaining and standard asset lives, which the initial RAB value is sensitive to. The FFO/Net debt ratio is sensitive to the regulatory depreciation allowance, which in turn depends on the weighted average life of the assets within a regulated business' RAB. If the weighted average asset life assumptions adopted in the model do not reflect the weighted average life of Watercare's existing and future assets, then the forecast regulated revenues may be materially lower or higher than is required to meet the FFO/Net debt target. Watercare's concern is that no rationale has been offered for the weighted average life assumptions adopted in the current version of the model, and that the initial RAB is sensitive to the assumed asset lives.
153. In summary, Watercare does not support the proposed approach to setting the initial RAB value. It is highly dependent on assumptions and uncertain forecasts, which, under an FCM model, cannot realistically be revisited in the future to address adverse consequences. It is not consistent with the FCM principle or promoting regulatory stability or certainty. For these reasons, Watercare is not confident that the proposed approach would in fact support Watercare's ability to meet its financial sustainability and revenue sufficiency obligations.

Watercare's GAAP asset value

154. The Approach Paper identifies several reasons why Watercare's GAAP asset values are not considered a suitable basis for the initial RAB, including the inclusion of assets not used for regulated services, vested assets that Watercare did not pay for, revaluations, and potentially assets funded through Infrastructure Funding and Financing (IFF) project special purpose vehicles (SPVs).²²
155. Watercare acknowledges that unadjusted GAAP asset values are unlikely to be directly suitable for use as a RAB under an FCM framework, particularly where valuation adjustments have been made, and contributions towards capital investments have been directly funded by consumers.

²⁰ Ofwat, Aligning risk and return, PR24 final determinations, December 2024, p. 5. <https://www.ofwat.gov.uk/wp-content/uploads/2024/12/PR24-final-determinations-Aligning-risk-and-return-1.pdf>

²¹ Moody's, Rating methodology – Regulated water utilities, 18 August 2023

²² Approach Paper, para 4.54

156. We also note that in other regulated sectors the cost and asset allocation IM specifies the rules for allocating shared assets between regulated and unregulated services, and that this method can also be applied to Watercare's initial RAB.
157. The Approach Paper dismisses GAAP-based asset values for the initial RAB but acknowledges that adjusted GAAP values may be appropriate for smaller entities.²³ Watercare sees no sound reason why an adjusted GAAP-based RAB could not be applied to Watercare, provided it delivers outcomes consistent with FCM, long-term consumer benefit and financial sustainability.
158. Watercare considers that GAAP-based asset values have a role to play in determining the initial RAB as they reflect important and relevant information consistent with historical investments funded by consumers for the purpose of providing water and wastewater services.
159. In particular, GAAP accounts reflect detailed, independently audited records of the actual assets in use to provide regulated services, including information by asset category and expected remaining service life. This information can be used to estimate the consumption of asset capacity over time and to allocate costs to users on an intergenerational basis. GAAP accounts also record the value of vested assets.
160. GAAP asset information therefore provides a robust evidential foundation that can be used, subject to appropriate adjustments, to determine a DHC initial RAB consistent with FCM. Adjustments may be required for unregulated assets, vested assets, revaluations and impairments, but this does not negate the relevance of the underlying data about the actual assets employed in the provision of regulated services.
161. The Approach Paper notes that the initial RAB values for EDBs, gas networks and airports were established using a 'line in the sand' approach based on existing regulatory valuations under the regulatory regimes in force prior to the introduction of sector specific regulation under Part 4. The Approach Paper goes on to briefly determine that:
- "for Watercare...there are no pre-existing regulatory asset values. So, a similar line in the sand approach, based on such values, cannot be implemented"*²⁴.
162. As set out above, Watercare considers that historical GAAP based asset values (appropriately adjusted and rolled forward) would provide a robust 'line in the sand' from which to determine Watercare's initial RAB value.
163. More detail about our proposed approach is included in paragraphs 179 to 188.

8. COST OF CAPITAL

164. Cost of capital plays a significant role in setting allowed revenues under the BBM framework proposed in the Approach Paper. The product of the cost of capital allowance and the RAB determines the return on capital allowance, which is typically one of the largest drivers of regulated revenue.
165. However, the Approach Paper is silent on the method for setting the cost of capital allowance for Watercare. Given the importance of the cost of capital in driving allowed revenues, Watercare seeks clarity on the cost of capital method that will apply when the Commission makes PQP

²³ Approach Paper, para 4.54

²⁴ Approach Paper, para 4.58

determinations. To that end, Watercare is willing to engage early with the Commission to develop together a cost of capital method that is appropriate to Watercare's circumstances.

166. The Commission has developed a cost of capital method that is broadly consistent across the various industries it regulates. That approach involves estimating a WACC for the regulated industry. This WACC allowance comprises:
 - 166.1. a benchmark cost of debt allowance; and
 - 166.2. a benchmark cost of equity allowance,where the relative weights applied to the allowed cost of debt and the allowed cost of equity are determined by a benchmark gearing assumption adopted by the Commission.
167. Watercare would support the application of this framework to estimate the cost of capital, with the details of the specific methods to be used to estimate individual WACC parameters to be determined through a consultation process that would allow Watercare and other stakeholders to provide input.
168. As noted above, the proposed model for determining an initial RAB value allows assumptions to be made about:
 - 168.1. the allowed cost of debt; and
 - 168.2. the allowed "cost of notional contributed capital", rather than an allowed cost of equity.
169. The quantum of notional contributed capital in the model is determined as the difference between the RAB value in each year and the total quantity of actual/assumed debt in that year. Hence, notional contributed capital in the model is analogous to equity in a standard BBM framework.
170. Whilst the model permits different values to be adopted for the allowed cost of debt and the allowed cost of notional contributed capital, the default approach in the model is to set these two rates of return equal to one another. Under these settings, Watercare would be assumed to receive no cost of equity allowance at all, and that equity capital only needs to be compensated for risk as though it was debt capital.
171. Watercare understands that the model is only intended to illustrate how it proposes to set Watercare's initial RAB value. However, Watercare submits that an approach that provides no cost of equity allowance would be entirely inappropriate.
172. Watercare recognises that LG Act provides that:
 - 172.1. Council must not receive any equity return from Watercare (s. 56A(1)(b)); and
 - 172.2. Watercare must not pay any dividends or distribute any surplus in any way, directly or indirectly to its shareholder (s. 57(1)(b)).
173. These provisions do not mean that Watercare does not require a return on equity capital invested. Section 56A(1)(c) of the LG Act provides that the Council must not give Watercare any financial support or capital. This prohibition means that Watercare cannot access new equity capital from its shareholder—a restriction that applies to no other business regulated by the Commission.
174. As a consequence, the only way Watercare can finance new investment is through:

- 174.1. new debt; and/or
 - 174.2. retained earnings/accumulated surpluses.
175. If the Commission provides Watercare with no cost of equity allowance, Watercare will be unable to accumulate surpluses that can be used to finance new investment, and would therefore have to rely entirely on new debt. A sufficiently large investment programme could result in imprudently high gearing that could imperil Watercare's credit rating.
176. Watercare submits that the Commission should adopt a standard framework where it sets allowed revenues for Watercare using an allowed cost of equity as well as an allowed cost of debt. The cost of equity allowance should be set in such a way as to take account of Watercare's forecast prudent and efficient capital expenditure over each forthcoming regulatory period - noting that a benchmark efficient business in Watercare's circumstances would need to finance the notional equity share of any future (non-growth) capital expenditure using retained earnings/accumulated surpluses.
177. Watercare submits that the notional quantities of equity and debt should be determined by applying a benchmark gearing assumption to the RAB, consistent with the approach applied by the Commission when setting PQPs for electricity, gas and fibre networks.

9. AN ALTERNATIVE APPROACH

178. Watercare proposes the following, alternative approach that would satisfy the financial sustainability and revenue sufficiency obligations.

Deemed Historical Cost RAB based on Watercare's establishment values

179. Firstly, Watercare's initial RAB should be set by reference to historical costs. The Approach Paper asserts that:

In practice, it could be difficult to determine the actual historical cost of Watercare's existing assets, particularly vested assets. It is also possible that setting the initial RAB equal to the actual historical cost of the existing assets would result in an insufficient level of revenue. Therefore, our preference is that the initial RAB would be established with a 'deemed' historical cost.²⁵

180. However, this claim has not been tested by the Commission. Watercare is able to work with the Commission to develop an initial RAB value using historical cost information. An initial RAB value set on this basis would satisfy the FCM principle as it would allow Watercare to recover the cost of historical investments in its RAB prior to the commencement of PQ regulation.
181. In Watercare's case, a DHC valuation derived from historical records is particularly appropriate given the way the entity was established. Watercare was created in FY11 following the reorganisation of Auckland's local authorities, at which point the water and wastewater assets of the contributing councils were legally vested into Watercare. The value of those assets, and the transfer of associated liabilities, was formally approved through enabling legislation,²⁶ which came into force on 1 November 2010. This provides a clear and legislatively sanctioned reference point for establishing an initial DHC.

²⁵ Approach Paper, para 4.35

²⁶ Including the Local Government (Auckland Transitional Provisions) Act 2010 and the Local Government (Tamaki Makaurau Reorganisation) Watercare Services Limited Vesting Order 2010.

182. Under a DHC approach, the initial RAB would be established from the Watercare integration date using the vesting values and rolled forward using standard regulatory methods. This would involve adding subsequent capital expenditure at cost, net of the value of vested assets and applying annual depreciation based on GAAP depreciation rates.
183. Applying CPI indexation would be consistent with indexing the RAB in the future and the expectation that RAB increases with CPI. However, Watercare proposes a conservative approach without indexation, which is more consistent with the approach adopted when establishing the initial RAB for Chorus.
184. Importantly, this valuation approach is grounded in information that directly ties to the actual assets employed in providing regulated water and wastewater services and the capital invested in those assets. This makes it well suited to long-term roll-forward and cost recovery under FCM.
185. Our initial investigations suggest that it is possible to use Watercare’s existing asset register and financial reporting information and to make the adjustments required to derive a DHC from vesting date. The information available is also consistent with the granularity which supports the RAB roll forward process once the initial RAB is established.
186. Figure 2 below summarises our assessment of the modelled RAB approach to DHC proposed by the Commission, and the DHC approach based on Watercare’s establishment values proposed in this submission. The evaluation uses criteria sourced from relevant legislation and the Approach Paper.

Figure 2: Evaluation of Deemed Historical Cost options for the Initial RAB

| | Criteria under a FCM approach | DHC based on proposed modelled RAB approach | DHC based on Watercare’s establishment values |
|-----------------------------------|---|---|--|
| Initial RAB Value | Measures the economic value of capital invested in Watercare’s regulated network assets, consistent with FCM (Approach Paper 3.11) | Ignores the investments made in assets to date | Reflects the assets that have been invested in to date |
| | Promotes Part 4 purpose, particularly incentives to invest and limiting excess profits (Part 4, s52A) | Less consistent as independent of the value of invested capital | More consistent as derived from the value of invested capital |
| | Consistent with revenue and investment sufficiency, and financial sustainability (LGWS Act s18(1)(a)) | May be consistent subject to initial settings, but divergence between forecast and actual settings may compromise future outcomes | More consistent, as explicitly addressed through application of FCM/Building Block levers such as indexation, when capex enters the RAB and financeability cross checks for each PQP |
| | Promotes certainty - once set the initial RAB generally should not be amended (Approach Paper 4.33) | Less consistent as based on forecast information - reliant on assumptions and judgements about long term cashflows beyond the initial regulatory period, which may not be durable | More consistent as based on historical information about the assets in use at the start of PQP regulation |
| Roll forward of Initial RAB Value | Reflects predictable rules to value, add, depreciate and dispose of assets from the RAB from one year to the next (Approach Paper 3.11) | Less consistent. Assumptions required to create basis for roll forward | More consistent as derived from accounting register information, suited to annual roll forward adjustments |
| | Depreciation provides for recovery of capital costs incurred - over economic life of assets (Approach Paper 3.27) | Less consistent as depreciation set to match assumed cashflow profile | More consistent as depreciation reflects consumption of actual physical assets over time, as recorded in the Watercare’s asset register |
| | Assets physically disposed are removed from the RAB (Approach Paper 4.45) | Not consistent, as initial RAB value independent of assets in use | Consistent as initial RAB asset register reflects assets in use |
| | Use of GAAP accounting information minimises compliance costs (Approach Paper 4.5) | Not consistent as independent of GAAP asset register information | Consistent as derived from GAAP asset register information |

187. As illustrated above, these factors suggest that a DHC value, anchored in Watercare’s legislatively approved establishment values and rolled forward using transparent and well-understood rules and audited asset information, represents a preferable alternative to a DHC based on a modelled RAB.
188. Setting the initial RAB based on Watercare’s establishment values is also more consistent with FCM and more principled than the proposed modelled RAB approach which relies on significant judgements and untested assumptions, not grounded in empirical evidence. Forecast modelling should be limited to cross-checking for financeability and price shocks, not to set the value of the initial RAB.

Satisfying financial sustainability and revenue sufficiency obligations

189. Once the initial RAB has been determined on this basis, the Commission would set a revenue allowance for Watercare using a BBM framework, in the same way it does for electricity, gas and fibre networks. In doing so, the Commission would:
- 189.1. set a benchmark cost of equity allowance;
 - 189.2. set a benchmark return on debt allowance;
 - 189.3. determine a benchmark capital structure (i.e., benchmark gearing), which would in turn define the benchmark quantity of debt for Watercare in each year, which may differ from Watercare’s actual quantity of debt. This would mean that Watercare’s allowed revenues would only be set to reflect a benchmark gearing ratio, rather than Watercare’s actual gearing ratio, to preserve incentives for Watercare to finance itself prudently and efficiently in a way that promotes the Part 4 purpose;
 - 189.4. adopt a benchmark credit rating assumption, as it does when regulating businesses in other industries;
 - 189.5. set a depreciation allowance reflecting the weighted average remaining life of Watercare’s existing asset base, and the weighted average life of any new assets that Watercare invests in, in future; and
 - 189.6. adopt forecasts of prudent and efficient expenditure over time, which are updated from one regulatory period to the next.
190. The financial sustainability and revenue sufficiency obligations would be satisfied as described in the following paragraphs.
191. The PQP should provide the business with sufficient cash flows over the regulatory period to maintain the benchmark credit rating, at the benchmark level of gearing. That is, the regulatory framework should provide the business with sufficient cash flows to comfortably meet its debt obligations, assuming it has geared up to the benchmark level, such that there is no expected deterioration in the business’s credit rating below the benchmark rating assumed when setting the PQP.
192. If the regulated cash flows meet this requirement, the business would be considered ‘financeable’. However, if the expected regulated cash flows to the business over the regulatory period are insufficient to support the *benchmark* credit rating at the *benchmark* level of gearing, the Commission should adjust the PQP to increase the regulated cash flows available, to rectify this internal inconsistency.

193. Watercare notes that the Commission recently developed a ‘financeability test’ to assess the sufficiency of regulated cash flows for regulated EDBs over DPP4.²⁷ That test was conducted entirely on a ‘notional’ (i.e., a benchmark) basis, as opposed to seeking to secure the financial sustainability of the actual supplier.
194. A similar test, tailored appropriately to regulated water utilities, could be developed and applied by the Commission when making PQP determinations for Watercare. We note that financeability tests are used by regulators (including regulators of water utilities) in Australia and the UK.
195. The role of financeability tests is to check the internal consistency of PQP decisions to ensure that a benchmark efficient business would have, over a forthcoming period, sufficient regulated cash flows to remain financeable. The test would be repeated each time the Commission makes a PQP decision, rather than being a ‘set and forget’ assessment to determine Watercare’s initial RAB value.
196. One of the stated reasons in the Approach Paper for pursuing a ‘deemed’ historical cost approach, rather than an actual historical approach, to setting the initial RAB is that the latter may result in insufficient revenue to satisfy the financial sustainability and revenue sufficiency obligations. Watercare submits that if the Commission were to apply an appropriate financeability test when making PQP determinations, and act when a financeability problem is identified, there should be no reason why the financial sustainability and revenue sufficiency obligations would not be met.

10. RAB ROLL FORWARD METHODOLOGY

197. Watercare considers that the design of the RAB roll-forward methodology is a critical component of an FCM-based regulatory framework, as this will materially affect investment incentives, financeability, and the profile of cost recovery over time. These choices also influence the extent to which regulated revenues are aligned with asset consumption, renewal cycles and long-term service outcomes.
198. Poorly specified roll-forward rules risk undermining the core objectives of FCM by distorting incentives to invest, increasing regulatory uncertainty, or creating volatility in cash flows and prices that are not reflective of underlying asset use. This may result in outcomes which are inconsistent with a fair allocation of costs over time to users of regulated infrastructure.

Asset registers

199. The roll-forward methodology will determine the ongoing implementation process and complexity of maintaining regulatory asset information. Overly granular or bespoke approaches may impose unnecessary compliance costs, particularly in the early stages of regulation, while overly aggregated approaches risk loss of transparency and robustness.
200. Watercare is unable to comment definitively on the appropriate level of asset register disaggregation for regulatory purposes until there is greater clarity on:
- 200.1. the method adopted to establish the initial RAB; and
 - 200.2. the roll-forward approach that will apply under the PQP.

²⁷ Commerce Commission, EDB DPP4 Reasons paper, Attachment G – Financeability, 20 November 2024.
https://www.comcom.govt.nz/assets/pdf_file/0029/363287/EDB-DPP4-Final-decision-Reasons-paper-Attachment-G-Financeability-20-November-2024.pdf

201. Convention in other regulated sectors is to maintain a detailed RAB register reflecting standard asset categories, depreciation rates and remaining asset lives, which enables accurate annual roll-forward adjustments and depreciation calculations for the RAB. Determining the initial RAB on a DHC basis derived from Watercare's establishment values will provide an appropriate basis for the asset register and the calculation of the annual depreciation adjustments required for the RAB roll forward.
202. There is precedent in other regulated sectors for adopting a more aggregated roll-forward approach for PQP forecasting purposes, while requiring greater disaggregation for disclosure, reconciliation and audit purposes. Precedents from IMs in other sectors will be informative, although Watercare notes that there will be sector-specific considerations for water and wastewater services, including asset heterogeneity and particularly long asset lives for some assets.
203. For financial reporting purposes, Watercare reports property, plant and equipment (**PPE**) values using a limited number of high-level reporting categories plus capital work in progress (**WIP**). However, Watercare's underlying financial systems maintain significantly more granular data, reflecting a wide range of asset types, ages and service lives. This provides a strong foundation for developing a detailed regulatory asset register.

Commissioned assets

204. Clear and comprehensive commissioned asset rules are essential to support the effective application of FCM and to provide regulatory certainty. There is significant regulatory precedent that can be relied on in this respect.
205. Consistent with the FCM principle, and the expectation that regulated suppliers recover their prudent and efficient investment in regulated assets over time, the following commissioned asset approaches are a useful starting position for consideration:
- 205.1. additions enter the RAB at cost, net of any contributions from customers;
 - 205.2. capitalisation rules are aligned with GAAP to promote certainty, transparency and minimise unnecessary compliance burden;
 - 205.3. allocation rules are used for assets which provide both regulated and non-regulated services, to be based on a proportionate sharing method;
 - 205.4. financing costs incurred prior to commissioning are included, to avoid underfunding capital-intensive projects and undermining financeability; and
 - 205.5. commissioning dates are aligned to recognition under GAAP, including recognising staged commissioning for significant assets constructed over multiple years. This is important for ensuring revenue allowances are sufficient to fund capex during prolonged construction periods.
206. We note that an alternative incurred capex approach could be considered for Watercare, given its anticipated significant investment programme going forward. This approach allows capex to enter the RAB when incurred. This would be a simple approach to adopt and would assist Watercare to finance its investments.

207. Land held by Watercare is used for Watercare's operations, including land associated with treatment plants, reservoirs, dams, landfill sites and wastewater disposal assets. While some land parcels may be acquired in advance of planned developments, Watercare does not hold significant land investments that are not used, or expected to be used, in the near term.²⁸

Depreciation on capital additions

208. Depreciation is the mechanism through which the value of capital investment is recovered over time and is therefore central to the operation of FCM. Watercare considers that depreciation rules should be aligned with GAAP to promote certainty, transparency and minimise complexity. This will include:
- 208.1. standard depreciation rates derived from economic asset lives by category, and aligned to GAAP rates and asset lives;
 - 208.2. straight-line depreciation as the default method; and
 - 208.3. allowing depreciation in the year of commissioning to align to GAAP treatment and remove unnecessary complexity that has arisen in other sectors due to artificial timing conventions. The incurred capital approach noted above also reduces complexity as commissioning dates are not required for depreciation purposes.
209. Where IGCs or capital contributions are deducted from the value of capital additions but not assigned to specific physical assets, appropriate depreciation rules will be required to avoid distortions and ensure an equitable profile of cost recovery over time, aligned to the underlying assets which are being funded.

Asset disposals

210. Watercare supports aligning regulatory and GAAP treatment of asset disposals for simplicity and transparency. Gains and losses on RAB disposals should be recorded in the regulatory accounts to ensure that FCM is met and that consumers neither overpay nor underpay for disposed assets. This will require sufficiently disaggregated RAB register information to accurately identify and account for asset disposals.

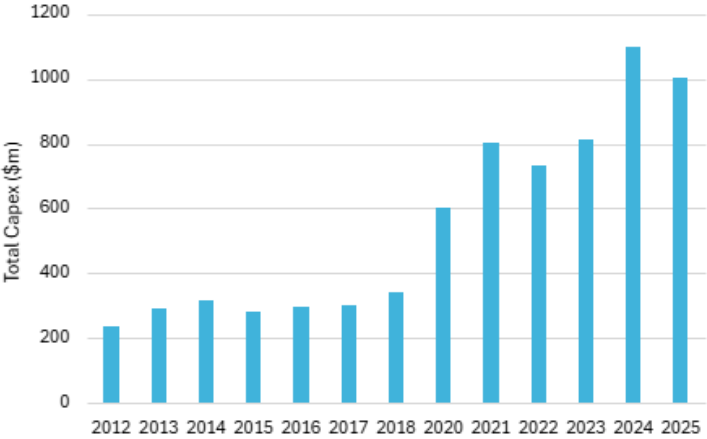
Revaluations

211. Watercare notes that the Approach Paper provides limited information about purpose of annual inflation indexation in the RAB under FCM, including the circumstances in which indexation will or will not be applied.
212. Watercare supports, in principle, the application of real FCM as described in the Approach Paper, under which assets are held at historical (or deemed historical) cost, depreciation provides for the recovery of capital already incurred, and any revaluation gains are treated as income for the purpose of earning a return.
213. Consistent with this logic, Watercare understands that under a real FCM framework any revaluations of the RAB will generally be limited to annual consumer price index (**CPI**) indexation, with resulting revaluation gains treated as income and deducted from allowable revenue under the BBM. This approach is consistent with preserving the real value of financial capital (represented by the RAB) over time, while avoiding windfall gains associated with discretionary or market-based revaluations.

²⁸ Watercare also leases and manages forestry land in the Hunua Ranges which is owned by the Council. On this land, pine trees are being replaced with natives to mitigate the detrimental impact on water quality from the pine plantations.

- 214. In practice, the appropriateness of CPI indexation depends on its consistency with other elements of the regulatory framework, particularly the treatment of inflation, whether the allowed rate of return is specified on a nominal basis, and the assumed time profile of capital cost recovery.
- 215. Even where CPI indexation is conceptually aligned with FCM, it can have material cash flow and price-path impacts in the short to medium term. RAB indexation has the effect of backloading the recovery of the asset-based building blocks. This is particularly important for Watercare during a transition into a BBM, where current and future investment requirements are significant.
- 216. Watercare notes that regulatory precedent is that indexation settings can differ across sectors and evolve over time to support financeability objectives. For example, RAB indexation was not adopted for Transpower for the first three regulatory periods due to negative cash flow impacts at a time when Transpower was undertaking significant capital investment.
- 217. An alternative hybrid approach, recently adopted in the UK, is to index only the equity portion of the RAB. This would result in Watercare receiving a full nominal return on debt in each regulatory period, which would be consistent with Watercare’s debt costs which would be in nominal (rather than real) terms.
- 218. For an entity such as Watercare, with a large and growing capital programme, the interaction between indexation, depreciation, revenue smoothing and financeability objectives is therefore highly relevant. As illustrated below, it is only since 2020 that Watercare has started to address historical underinvestment in Auckland’s water and wastewater infrastructure. This elevated level of investment is expected to continue, and increase, as demand for water services continues to grow across the Auckland region, and Watercare seeks to maintain the service performance of its assets.

Figure 3 – Watercare’s annual capex (2012 - 2025)



- 219. Accordingly, Watercare considers that CPI indexation should not be treated as a purely technical regulatory accounting choice, but rather as a material design decision that needs to be assessed alongside the objective of maintaining investment-grade financial metrics and supporting efficient investment and cost recovery over time.

Tax loss asset

- 220. Watercare is income tax exempt and expects this status to continue for the foreseeable future. Watercare has a tax loss asset which was primarily created due to the difference between tax depreciation and accounting depreciation. This asset is available to the wider Council Group and

currently Watercare receives compensation for any tax losses used within the Council Group. The utilisation of tax losses is therefore dependent on the annual financial performance of other entities.

221. Watercare considers that the treatment of tax losses should be addressed in a manner that is internally consistent with the overall regulatory framework and FCM principles, and will engage further with the Commission in this respect.

11. OTHER DECISION-MAKING TOPICS FOR PQPS

222. Watercare looks forward to engaging further with the Commission on PQP design choices. These decisions are fundamental to how Watercare prepares its PQP proposal, and early resolution is important to support efficient and effective engagement.

Focus on the essentials for the first PQP

223. Watercare supports an approach for the first PQP which focusses on essential regulatory elements. There may be an opportunity to adopt and adapt some of the features of PQ regulation which apply in sectors with more mature regulatory regimes if more time is available.
224. In any event, a measured approach to the initial PQP periods is supported. This approach recognises that:
- 224.1. introducing all features of a fully developed regulatory regime in the initial PQP risks unnecessary complexity and unintended consequences; and
 - 224.2. compliance requirements can appropriately evolve over time.
225. Accordingly, Watercare's transition to PQ regulation may better promote regulatory predictability, and long-term consumer benefit with:
- 225.1. a staged or transitional application of PQP requirements;
 - 225.2. early consultation on foundational methodologies;
 - 225.3. proportionate scrutiny and verification of the first PQP proposal; and
 - 225.4. deferral of complex mechanisms better suited to IMs or later regulatory periods.

Propose/respond model

226. The Approach Paper²⁹ proposes that a propose/respond model is adopted for determining Watercare's PQP, including proposed quality standards, performance measures, expenditure forecasts and any associated incentives. Watercare supports the use of a propose/respond model in principle.
227. The propose/respond model is commonly used to set PQPs in other regulated sectors. When well designed, the model allows regulated suppliers to put forward integrated proposals that reflect their specific circumstances, subject to regulatory scrutiny and amendment where required.
228. However, in other sectors the propose/respond model is typically underpinned by clear and settled IMs, which define:

²⁹ Approach Paper, para 5.3 and 5.9

- 228.1. the rules and processes that apply;
 - 228.2. the information to be provided;
 - 228.3. the criteria against which proposals will be assessed; and
 - 228.4. the timing and sequencing of engagement and decision-making.
229. These elements are critical to ensuring that the propose/respond model operates efficiently and delivers predictable, durable outcomes. In the absence of such clarity, there is a risk that the model becomes overly burdensome, opaque or inconsistent, particularly in the first regulatory period.

Quality standards and performance requirements

230. Watercare expects to undertake customer consultation to support its proposals on quality standards. However, given the compressed timeframe for the first PQP and the broader reform programme underway, such consultation may need to be more targeted than might be expected in future regulatory periods.
231. Watercare also notes that there is insufficient time to undertake extensive mandated consultation for the first PQP prior to submission of the initial proposal in early 2027. Limited information at this time on the intended approach to evaluating quality standards and performance requirements is a constraint, given Watercare must begin preparatory work now.
232. Regulatory precedent indicates that PQPs typically include a limited number of core quality standards. It is also noted that the Charter performance reporting requirements are already extensive and that ID requirements are expected, over time, to replace much of the Charter reporting. Accordingly, Watercare considers that ID should be the primary mechanism for ongoing performance monitoring, with PQP requirements focused on core standards.
233. In addition, Watercare, like other water entities, is already subject to multiple performance standards through other regulatory regimes, including:
- 233.1. health and drinking water standards;
 - 233.2. environmental standards; and
 - 233.3. local authority requirements.
234. The PQP framework should recognise this broader regulatory context and avoid duplicating or conflicting requirements. Therefore, for its first PQP under Part 4 Watercare considers it appropriate to:
- 234.1. report and monitor performance against a limited number of key measures;
 - 234.2. defer consideration of binding regulated standards (minimums or maximums) to subsequent PQP periods once the regime has matured; and
 - 234.3. leverage existing experience and initiatives under the Charter, including established performance reporting, to provide continuity and reduce implementation risk.

Expenditure forecasts

235. Watercare looks forward to engaging further on the proposed approach to regulating Watercare's expenditure proposal for the first PQP period. However, given the proposed timetable, preparation of the PQP proposal must commence immediately, unless deferred as suggested earlier in this submission. Watercare therefore requires early direction on:
- 235.1. assessment criteria for expenditure and quality proposals;
 - 235.2. methodology and approach expectations; and
 - 235.3. information, audit, consultation and verification requirements.
236. We consider that there are opportunities to streamline the standard propose/respond processes for the first PQP under Part 4 to ensure proportionality and focus on the most material issues. The degree of streamlining necessary will depend on the process decisions yet to come, and whether our proposal for an extension to the first regulatory period under the Charter is accepted.
237. Options for streamlining and proportionate scrutiny include:
- 237.1. targeting the verifier's terms of reference to the most material projects and programmes and adopting alternative analytical approaches (similar to electricity network default price-quality paths) for remaining capex and opex;
 - 237.2. limiting the volume of documented evidence required to support the PQP proposal, and using workshops with Watercare to evaluate key aspects of the proposal;
 - 237.3. adopting a targeted stakeholder consultation process; and
 - 237.4. relying on Crown Monitor insights into Watercare's expenditure, efficiency, project and programme delivery and quality standard performance, obtained under the Charter.

Expenditure incentives not suitable for first PQP

238. Watercare considers that the introduction of additional explicit expenditure incentive mechanisms is not desirable for the first PQP under Part 4. This is acceptable, and consistent with consumer interests because the PQP framework itself provides inherent efficiency incentives. Expenditure allowances are fixed for the duration of the regulatory period, which incentivises Watercare to manage costs efficiently. In addition, scrutiny and approval of the expenditure proposal establishes explicit efficiency expectations that Watercare must meet over the regulatory period.
239. The propose/respond model for setting expenditure allowances for water services is new in New Zealand. Both Watercare and the Commission are still developing experience with how this model should operate in practice for the water sector, including how expenditure proposals should be prepared, assessed and verified.
240. There is only a short period of time available for expenditure forecasts to be prepared, scrutinised and assessed for the first PQP under Part 4. In addition, proposed changes to the Resource Management Act (**RMA**) and the Council's Unitary Plan will impact Watercare's ability to forecast demand and expenditure with a high degree of certainty.
241. In this context, incentive mechanisms are more likely to reward or penalise forecasting error — arising from uncertainty or immature processes — rather than genuine improvements in expenditure efficiency.

242. Additional incentive mechanisms will add further complexity to the first PQP at a time when simplicity, proportionality and regulatory predictability are particularly important. This complexity is undesirable in the absence of clear and settled rules and processes and increases the risk of unintended consequences.

Form of control

243. Similar to the current revenue cap under the Charter, Watercare supports a revenue cap with wash-up form of control, which provides more revenue certainty than a weighted average price-cap. This reduces regulatory risk, and therefore the costs of providing water and wastewater services.
244. Watercare's costs comprise both variable costs (e.g., energy and chemicals) and fixed costs (e.g., asset-related costs and planning and business support costs). Over time, it is expected that Watercare's user charges may evolve to ensure alignment of costs and tariff structure. But precedent from other regulated sectors indicates that weighted average price caps may create barriers to pricing reform within a PQP period, and are dependent on the ability to accurately forecast billable quantities.
245. Watercare's revenues are more dependent on the weather, and therefore outside of Watercare's control, than for regulated suppliers in other sectors.
246. Watercare supports a single revenue cap covering both water and wastewater services because these services are highly interrelated and customers typically contract for integrated services. We note that Watercare's operations, asset management, investment planning and debt funding are integrated, as demand for water supply ultimately determines wastewater disposal requirements. We consider that the ID regime is the appropriate regulatory mechanism to monitor water and wastewater performance, avoiding unnecessary complexity in the PQP.
247. Watercare seeks clarity on which costs will be passed directly through to customers, including Commerce Act levies and other costs outside Watercare's control.
248. Watercare expects that there will need to be a transition onto the first PQP which is based on the BBM. We support the use of smoothing where necessary to manage pricing impacts, subject to meeting financial sufficiency and sustainability objectives. Watercare looks forward to working with the Commission on pricing and funding impact analysis in due course.

Timing and duration of first PQP

249. As noted earlier, Watercare supports deferring the initial BBM based PQP by extending the first regulatory period under the Preliminary Arrangements Act and applying price-quality settings under the Charter with appropriate adjustments. This will allow more time for Watercare to prepare its first PQP proposal, and for key IMs and foundational regulatory settings to be determined.
250. Notwithstanding this proposed deferral, it may also be appropriate to:
- 250.1. adopt a three-year PQP period initially, with longer periods in future once the regime matures; and
 - 250.2. allow reopeners to respond to unforeseen events, financeability concerns, legislative change and major projects that become more certain over time.

251. The duration of future regulatory periods will also be influenced by the scheduling of the determination and implementation of IMs, and the time available for Watercare to prepare and submit a PQP proposal consistent with the IMs.

12. GLOSSARY

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| AMP | Asset management plan |
| Approach Paper | Price-quality path for Watercare – Approach Paper |
| BBM | Building blocks model |
| Charter | Local Government (Water Services Preliminary Arrangements) (Watercare Charter) Order 2025 |
| Commerce Act | Part 4 of the Commerce Act 1986 |
| Commission | Commerce Commission |
| Council | Auckland Council |
| CPI | Consumer price index |
| DHC | Deemed historical cost |
| Discussion Paper | Discussion Paper on PQP design choices |
| FCM | Financial capital maintenance |
| GAAP | Generally accepted accounting practice |
| ID | Information disclosure |
| IGC | Infrastructure growth charge |
| IMs | Input methodologies |
| IPP | Individual price-quality path |
| LG Act | Local Government (Auckland Council) Act |
| LGWS Act | Local Government Water Services Act |
| Position Paper | Position paper on regulatory accounting |
| PQ | Price-quality |
| PQP | Price-quality path |
| RAB | Regulatory asset base |
| RMA | Resource management act |
| SOE | Statement of expectations |
| WACC | Weighted average cost of capital |
| Watercare | Watercare Services Limited |
| WIP | Work in progress |
| WSS | Water services strategy |