Thursday 30 July 2026

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Submission the Commerce Commission's Price-Quality Path for Watercare Emerging Views Paper.

This is an individual submission, it does not contain any confidential material, and I consent to it being made public.

In setting out the Commerce Commission's (Commission's) approach the Price-Quality Path for Watercare Emerging Views Paper (Paper) raises as many questions and issues as it answers. These are discussed in the body of my submission below for consideration in the development of Watercare Price-Quality Path (PQP).

Areas of increased uncertainty

The Commission has stated its functions do not extend to regulating the safety of drinking water, and so cannot set quality standards on this aspect of service delivery. This is because of s 57T of the Commerce Act (Act), which excludes the drinking water safety role of the Water Services Authority (Authority) from the Commission's functions. The water safety aspects referred to are not clearly defined in the Authority's enabling legislation and the ambiguity that this causes requires clarification and resolution with a high priority.

This is because if the Commission cannot set a quality standard for drinking water safety, it then follows that it cannot apply any other regulatory function relating to this aspect of water services. This includes matters relating to revenue and expenditure. Watercare's spend on drinking water safety and any recovery from consumers related to this must be considered outside the Commission's remit.

The recent information disclosure (ID) determination did not directly specify any drinking water safety items but effectively sidestepped the issue by requiring reporting against other items that did. It is worth noting that expenditure related to drinking water safety has not been specifically excluded from this, so any ID information including this would be technically non-compliant if not separated out, despite being more useful to stakeholders.

The Commission will not be able to evaluate or set any revenue limits for any expenditure, including what goes into the Regulatory Asset Base (RAB), for matters relating to drinking water safety. Nor will it be able to assess performance or direct any investment in relation to drinking water safety. This will have to be managed and reported by the Authority. However, these powers have not been given to the Authority.

It is questionable that this gap was the intent of the legislation, and so a s 100A finding should be sought to resolve this.

Similarly in need of clarification is that the Commission has indicated that it intends to evaluate expenditure from an Infrastructure Funding and Financing (IFF) special purpose vehicle (SPV). It is not clear that this falls within the Commission's remit either as this is not expenditure by a regulated supplier. The legal responsibility for design and costing and other decision making associated with the IFF investment remain with the SPV until the assets are vested with Watercare. If the IFF expenditure can be evaluated, then the Commission should also be evaluating the expenditure associated with other assets vested to Watercare i.e. by developers, to ensure that these are also in the long-term benefit of consumers. The Commission should seek a legal review and opinion, and potentially a s100A review, to reduce the uncertainty.

The Commission's approach and providing certainty

The Commission states that setting the Watercare PQP will enhance stakeholder understanding and increase predictability. But the Commission also says that the decisions only apply to the PQP for Watercare, so that the understanding and predictability provided is limited. This is despite stating in the paper that the Commission would take a learning approach, especially when dealing with the lack of Input Methodologies (IMs). It appears contradictory that any new water economic regulation will not take any learnings from the Watercare PQP.

Predictability and understanding are further limited without Input Methodologies (IMs) and the wait and see approach the Commission is proposing. This approach requires ongoing and extensive monitoring and analysis and management. The Commission has not said this will be delivered beyond the standard legislated periods for IMs to be established and waiting for the next regulatory control period (RCP) to be prepared. Instead, the Commission 'could monitor', but has not said what it will do. Without this certainty, stakeholders may reach the conclusion that the Commssion is not willing or able to address consumers interests.

The paper contains many things that the Commssion might do but does not commit to what the Commission will do aside from the minimum legally required. This makes statements about providing stakeholders with predictability and certainty open to question by stakeholders. When the Commission says 'it is likely to have regard to' this is not enhancing certainty.

It is unclear why the promotion of certainty (such as in 3.50.3) by clear specification of matters and the use of the building block approach cannot be applied to other areas where the Commission is prepared to take a wait and see approach or wishes for flexibility. The Commission risks appearing inconsistent to stakeholders by taking different approaches.

The Commission has said (6.28) it will monitor outcomes and similarly consumer outcomes (7.11). It is not clear what will be monitored (and what will not), when and how. There should be ongoing in period review assessment. This is particularly relevant with the lower levels of uncertainly and the wait and see approach being taken.

While often justifying the choices made in the paper as being consistent with other Part 4 regulation, the Commission has remained silent on cases when it has reached a different decision. It has not even identified that other options have been used in the past. This means stakeholders may be sceptical of the options, reasons, and decisions put forward by the Commission.

There were only two options put forward by the Commission for developing the initial RAB – physical and financial. Electricity and gas pipeline businesses initial RABs were based on a specified valuation process applied to the existing assets. However, the Commission has not presented this as an option despite there being a precedent for this.

Indexation of the RAB was also recognised as necessary when large amounts of investment were needed by Transpower. But the Commission has ruled this approach out despite the similar circumstances facing Watercare.

Despite relying on precedent for proposed approaches in the paper, the Commssion appears to be selective in the precedents it will permit to be used. This decreases the level of certainty for stakeholders.

The Commission has not explained how it has concluded the depreciated historical cost of infrastructure growth charges (IGC) is an effective proxy for revenue. And how it might accept a proxy in any other matter for setting or evaluating the PQP as effective. This affects the level of certainty the Paper provides stakeholders.

The Commission says its IGC approach can be applied because the economic effect is similar to other cases. That is, the form is not relevant, only the outcome. This is inconsistent with other positions that the Commission takes in the Paper where an approach is justified because it is that same form that has been applied before.

These mixed messages in the paper appear to show the Commission is happy to use different justifications to get the outcome it wants rather than relying on a consistent and predicable argument that can be understood and evaluated by stakeholders.

In the paper it is not clear if the Commission is solely focused on presence of the incentives in s 52A, the strength of those incentives or the actual delivery of outcomes to consumers.

The paper also discusses the social acceptability in some Commission decisions. However, it is not clear the extent to which the Commission will give weight to stakeholders' views, including the acceptance by consumers, in making decisions on the PQP. Without being clear on this, stakeholders may consider these aspects are only applied where it aligns with the Commission's chosen approach.

Consumers may consider they need to take other options, such as directly engaging with elected representatives, to get their expectations addressed.

Setting the Price Path

The Commission should consider developing a major investment function, similar to that used by Transpower and other regulated businesses, to address where there is uncertainty over the timing or accuracy of expenditure in an RCP. It is noted that Watercare has signalled large amounts of investment is intended and needs to improve its asset management functions. So, the necessary investment cases may not be fully developed for the independent verifier and Commssion to evaluate against the expenditure and efficiency objectives. This would mean necessary investment may not be included in the PQP. While the initial RCP is only three years, the functionality for additional investments to be included in the PQP should be built in.

Good water industry practice should develop efficient investment and actions in each regulated service. This should be supported by enabling cost allocation between regulated services. In establishing a combined revenue cap care should be taken to not to allow systems to be set up to make any separation in the future i.e. avoid initial path dependency and future justification that a change will be too costly.

Rates are not within Watercare's control, but they will be passed on directly to consumers and are in the control of Watercare's owner. The issues around this should be considered like a related party transaction.

There should not be a quality reopener. This could only be justified if there was a quality issue related to drinking water safety, which the Commission has stated it does not consider it can regulate at this stage.

Incentives in the PQP

The PQP is being set up so that Watercare will have the opportunity to earn a reasonable level of profit. Watercare will not be retuning this profit to shareholders and will have to determine what to do with it. If Watercare retains and reinvests earnings it is effectively weakening the incentives the Commssion is attempting to apply. In other Part 4 regulation the earnings are returned to owners. But Watercare will be reinvesting these funds and can use them as it sees fit.

If it appears Watercare might exceed the maximum allowable revenue (MAR) set by the Commission, it can use retained earnings to offset this and avoid breeching the PQP – reducing the inventive for efficient expenditure.

If earnings are reinvested in capital expenditure, this value is automatically added to RAB. Resulting in an increased value compared to solely consumer funded investment. As a result of any earnings boosted increase in RAB value, more revenue and earnings are allowed to be recovered from consumers. This effect will compound over the life of the assets, also weakening the incentives set by the Commssion

It is not clear that the Commssion can prevent Watercare from taking these actions under Part 4, as the earnings are not revenue recovered from consumers. However, this should assess the strength of its incentives if these actions are taken.

The initial RAB will be set to provide a return on and return of capital for all previous investment. This investment will not have been fully consistent with good water industry practice or meet the expenditure objectives discussed in the paper for new capital investment. As a result, the initial RAB will include inefficient costs that will be recovered from consumers for the remaining economic life of the assets. This contradicts and dilutes the effect of the incentives the Commission is putting in place.

It is interesting the Commission is valuing predictability in the setting of the RAB, but not in other areas where it willing to tolerate uncertainty. Consumers may consider the certainty their outcomes will be delivered is not given sufficient weight when the Commission is happy to take a wait and see approach on their behalf.

The paper appears to be limiting incentives under consideration to only those in s52A and ignores the impacts of making public statements on concerns, performance or raising up stakeholder views with Watercare. These are also legitimate to achieve outcomes and, as the Commission has indicated, the outcome is more important than the form.

Quality measures are needed to prevent under investment and incentivise efficiency, if the Commssion is going to develop its approach over time then there needs to be ongoing scrutiny of performance and outcomes. And a means to compensate consumers for any underdeveloped or missing incentives.

Performance requirements

Watercare needs to continue to make stated improvements in asset management maturity and operational efficiency. The delivery of these commitments should be demonstrated and assessed. Watercare may have committed to improving efficiency and asset management maturity, but that commitment does not provide certainty, and stakeholders do not know how well the incentives applied will support delivery. This is best achieved through a specified as a performance requirement rather than simply relying on Watercare's commitments.

The Commission made the point when discussing additional economic regulation for Tiaki Wai that the use of a performance measure provides necessary focus and direction to regulated suppliers. If the Commission believes it should be applying tools to assist financial sustainability, then it should also be using tools in other areas. If the Commission instead intends to rely on a commitment from Watercare without additional measures to ensure delivery post Charter, then there is no basis not to accept a commitment that Watercare will promote the Part 4 purpose and so any further intervention by the Commission is unnecessary.

The pricing reform being carried out also needs to be assessed against Part 4 and other relevant principles to ensure it is delivered and delivers efficiency. This is another case for a performance outcome.

The RAB

The Commission states that the initial RAB will be amended at the setting of the PQP but overlooks any found assets that were not included in the determination of the initial RAB. This frequently occurred for the regulation of electricity lines business relying on a physical RAB approach and is likely to occur with water services providers who do not have mature asset management capabilities.

Using statements about the acceptability of the RAB approach to stakeholders as a justification for the Commission's approach assumes that submitters are fully informed, and representative of all stakeholders. This is questionable when the

Commission has not presented all alternatives. It is also not clear the consumers views are fully represented in the feedback and they have the same level of specialist support the water industry and Watercare do.

WACC

The WACC is intended to allow for the recovery of efficient capital costs over time but also allows for the inefficient costs to be recovered from the initial RAB. The Commission should clearly explain to consumers why they must pay for past inefficient investment.

Stakeholders need a readily accessible and usable model to show the impact of the WACC decisions on the maximum allowable revenue (MAR). WACC is highly technical and complicated subject, and there is no consumer focus or meaningful ability to challenge what the Commission presents. The model produced by the Commission is not accessible by stakeholders without engaging specialist resources and so the information is not reasonably accessible to consumers. So, their ability to meaningfully submit is limited. This appears to be a principal agent problem, with no means for consumers to ensure the agent is acting in their interest. Consumers may consider other action is required to ensure the delivery of their outcomes

The Commission is essentially asking stakeholders to accept its technocratic process to produce an asset beta value. It is interesting that the Commission's assessment of a suitable asset beta is consistently higher than that generated by separate independent economic regulators regulating similar firms in a similar environment (which the Commission stated provided the best comparator for New Zealand). Given this, stakeholders may consider the Commission is putting too much confidence in its own process.

Other matters

The paper says that that demand is strongly influenced by weather and climate. This may be correct for water supply services but not for wastewater (note that I&I is not included in definition of the regulated service). This weakens the justification and suggests separate revenue setting in the future.

Watercare has bylaws and the contract to enforce demand management on consumers (unlike other regulated businesses the Commission uses as a comparator), this is a stronger driver then efficient pricing.

Watercare are naturally incentivised to put risk on other parties, so their endorsement of any approach should be carefully evaluated rather than simply used as justification of the Commission's approach

If the Commission does not have information, it does not have to rely on Watercare's proposal but can use s53ZD or other regulatory options provided so it can target and get exactly what is needed – not what Watercare offers.