Auckland Council
Te Kaunihera o Tāmaki Makaurau

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Commerce Commission
By email: wai@comcom.govt.nz

Auckland Council's submission on the Price-Quality Path for Watercare – Emerging Views Paper

Thank you for providing Auckland Council with the opportunity to submit on the emerging views paper regarding the price-quality path for Watercare.

Please contact Megan Tyler, Director Policy, Planning and Governance, [redacted] if you have any queries regarding Auckland Council's submission.

Ngā mihi

[redacted]
Megan Tyler
Director Policy, Planning and Governance

Price-Quality Path for Watercare – Emerging Views Paper

Auckland Council feedback

Introduction

Auckland Council welcomes the opportunity to submit on the Commerce Commission's emerging views paper for the price-quality path for Watercare. This submission is on behalf of Auckland Council as the shareholder of Watercare Services Limited.

A separate submission is being made by Watercare.

Tāmaki Makaurau Context

Auckland Council is a unitary authority and the largest council in Aotearoa New Zealand, serving over 1.7 million people. Watercare, a council-controlled organisation wholly owned by the council, is our water organisation for drinking water and wastewater services. Auckland Council sets strategic expectations and holds Watercare to account for the delivery of these services on behalf of Aucklanders.

In its roles as Watercare shareholder and as local authority representing the interests of Aucklanders, Auckland Council recognises the benefits of a regulatory regime for the water sector to support sufficient investment, financial sustainability, continuous innovation, efficiency gains, good quality services and affordable prices. We therefore support the Commission's proposed approach of setting a price-quality path that considers investment sufficiency, revenue sufficiency, and financial sustainability to achieve these objectives.

Basis for Submission

The Auckland population is projected to grow to 2.29 million by 2052. Accommodating this level of growth requires Auckland Council to coordinate development across all infrastructure groups – including community, transport, stormwater, drinking water and wastewater. In line with expected growth, it is both a political and strategic priority of Auckland Council to future-proof the Auckland Region's drinking and wastewater networks and services, which it delivers through its direction of Watercare. Given how variable the factors that affect growth are, Watercare requires a level of flexibility, both operational and financial, to respond to uncertainty.

Local water service providers are going through significant reform in relation to how they operate and how they are governed. Watercare's political direction will be given, in future, through a 'Statement of Expectations' outlining several objectives Auckland Council expects Watercare to achieve.

Among those priorities, we expect Watercare to commit to delivering affordable, safe and reliable water services while improving infrastructure delivery performance and operating efficiency. Immediate and ongoing achievement of these objectives rely on Watercare having the:

1. Ability to respond to political direction,
2. Flexibility and resilience to handle shocks, and
3. Capacity to maintain financial sustainability.

Auckland Council also has a relationship with Watercare as its sole shareholder, on behalf of Auckland residents. Our equity holding reflects a commitment to developing and maintaining a water network that reliably serves Aucklanders. In line with financial capital maintenance, we expect the real level of this equity investment to be maintained and that any regulatory framework recognises the opportunity cost and risks borne by equity, with those risks appropriately reflected in the regulated return.

Principles Underlying Submission

This submission builds on our previous submission by further articulating governance and shareholder perspectives on the Commission's emerging views and the principles that should underpin them:

- Fair valuation of regulatory assets,
- A cost of capital that reflects investment risk, and
- The maintenance of operational resilience.

Below, we outline our preferences where the Commission has proposed alternative treatments, positions which we support, and matters on which we seek further clarification.

Valuation of the Regulatory Asset Base (RAB)

Maintaining financial sustainability of Watercare and realising an appropriate real rate of return on equity both depend on appropriately valuing regulatory assets and accurately calculating Watercare's weighted average cost of capital.

Council Positions:

- We **support the Commission's conditional preference for the physical initial RAB valuation** that considers and makes necessary adjustments to existing asset valuations and useful lives (as opposed to a modelled financial RAB valuation), because such valuations have an accounting foundation that represents the economic reality of the assets held. A modelled financial RAB, by contrast, may be more focused on achieving a target revenue outcome, rather than faithfully representing the value of underlying assets. Our preference, like the Commission's, is **conditional on the physical initial RAB valuation providing financial sustainability** for Watercare.
- We **support the inclusion of Watercare's assets integrated from legacy Councils** in the RAB and the use of GAAP useful life for additions to the RAB. Integrated assets were financed by the water-service providers preceding Watercare, and Watercare's foundation did not remove the requirement for return of capital nor the expectation of return on capital.
- We **support the indexation of the RAB to inflation** provided that it supports Watercare's financial sustainability and allows for sufficient cash flows.

Calculating the Weighted Average Cost of Capital (WACC)

Council Positions:

- We **support the Commission's approach of allowing for costs of equity** in WACC calculations, because it recognises that Watercare's equity financing requires compensation, and would allow for sufficient returns that support Watercare's financial sustainability. Our support is for the broad approach, rather than specified estimates of the cost of debt and cost of equity.

Operational Resilience

Operational resilience requires Watercare to maintain the flexibility to respond to changing circumstances, including policy direction and unforeseen shocks, while maintaining financial sustainability. We support a regulatory approach that preserves this flexibility, where compliance obligations are proportionate and deliver commensurate benefit.

Council Positions:

- We **support a propose/ respond regulation model**, because it allows Watercare to specify expenditure required to best serve its customers.
- We **support provisions for in-period adjustments** in exceptional circumstances (including catastrophic events, legislative or regulatory change, error events, and financeability pressures), because it supports Watercare's resilience to financial shocks.
- We **support a single revenue cap**, because the allocation of asset values and operating costs between drinking water and wastewater add regulatory complexity without likely commensurate benefit for consumers.
- We **support mandating at least one service quality standard** to ensure that water quality and financeability are jointly maintained.
- We **support a three-year initial regulatory period** for PQP28 because this is the first water services price-quality regulation and a three-year period provides an opportunity to review and improve regulatory processes to ensure they are effective for future pathways.
- We **seek clarification of the timing of final decisions for the first price-quality pathway**, with a concern that the proposed timing does not provide sufficient time for Watercare to provide Auckland Council with an annual budget, as is mandated in legislation. We believe price-quality regulation would be most effectively implemented if there is regulatory certainty when budgeting decisions are being made.

Summary of Auckland Council Positions

Auckland Council considers the emerging views paper provides greater clarity on the direction of future price-quality regulation and supports many of the positions outlined by the Commerce Commission.

The Council also seeks clarification and justification of proposals that may reduce Watercare's flexibility to respond to policy expectations, and their capacity to provide high quality water services at affordable prices for Aucklanders. Ultimately, we seek regulatory settings that will allow Watercare to maintain its operational resilience while remaining financially sustainable so that current and future consumers realise the full potential benefits of price-quality regulation.

Alongside positions raised from governance and shareholder perspectives, Council extends support to Watercare and concerns they communicate in their own submission, such as financeability, investment sufficiency, resilienrce to shocks and maintaining service quality.