Watercare Services Limited
73 Remuera Road, Remuera,
Auckland 1050, New Zealand
Private Bag 92521, Victoria Street West,
Auckland 1142, New Zealand
Telephone +64 9 442 2222
www.watercare.co.nz

30 July, 2026

Charlotte Reed
Head of Water Regulation
Commerce Commission New Zealand

Via email: [redacted]

Tēnā koe Charlotte,

Watercare Price-Quality Path (PQP) Approach Paper Submission

Thank you for the opportunity to provide our submission on the Commission's Emerging Views paper for Watercare's first price-quality path. Please find our submission attached.

Watercare supports the Commission's objective of establishing a durable framework that promotes the long-term benefit of consumers and supports the application of established Part 4 principles where they are fit for purpose. However, these principles must be applied in a manner that reflects Watercare's operating, financing and ownership circumstances.

The Commission's emerging views and Watercare's position differ on a number of foundational regulatory settings. Collectively, these settings will determine whether the first price-quality path provides sufficient financial resilience, investment capacity and regulatory certainty to support the efficient delivery of water services in Auckland.

We have set out Watercare's position on each of these matters and the detailed principle-based reasoning for them.

We look forward to continuing to work constructively with the Commission to develop a first price-quality path that is financeable, deliverable and supports safe, reliable and resilient water and wastewater services for current and future Aucklanders.

Ngā mihi,

[redacted]

Jamie Sinclair

Chief Executive
Watercare Services Limited

Watercare Services Limited

Submission to the Commerce Commission on

Price-Quality Path for Watercare – Emerging Views Paper

30 July 2026

PUBLIC

Watercare

This page has been intentionally left blank

Table of Contents

EXECUTIVE SUMMARY 4
INTRODUCTION 7
FINANCIAL SUSTAINABILITY 14
SETTING THE INITIAL RAB 20
COST OF CAPITAL 24
PROCESS 29
QUALITY STANDARDS 31
REVENUE PATH AND RISK 32
VERIFICATION AND EXPENDITURE ASSESSMENT 35
INFRASTRUCTURE GROWTH CHARGES 36
THE COMMISSION'S DEMONSTRATION MODEL 36

EXECUTIVE SUMMARY

X1. Watercare provides water and wastewater services to 1.7 million Aucklanders. Every day we supply approximately 440 million litres of drinking water and treat approximately 439 million litres of wastewater. Watercare is not entering economic regulation from a steady state position. Over the next decade, Auckland requires Watercare to invest around $15.2 billion to renew ageing infrastructure, strengthen network resilience in response to increasingly frequent and severe weather events, and build the new infrastructure needed to support Auckland's future growth.

X2. This submission addresses the fundamental question: whether the first price-quality path will allow Watercare to finance and deliver that investment programme.

X3. Three features of Watercare's circumstances shape everything that follows in this submission.

a. First, Watercare cannot raise equity. Unlike other businesses regulated under Part 4, Watercare's shareholder is prohibited by legislation from providing additional capital. When financial pressure arises, Watercare cannot access shareholder funding to restore financial resilience.

b. Second, Watercare cannot pay dividends. As a result, Watercare does not have access to one of the key financial flexibilities available to other regulated businesses. Revenue collected from customers is retained within the business to support investment and maintain financial sustainability.

c. Third, Watercare is transitioning to a new economic regulatory framework at the same time as investment requirements are accelerating. The challenge is not simply setting an enduring regulatory model, but ensuring the transition occurs in a way that preserves investment capacity, financial resilience and efficient access to debt markets. Equally important, Watercare requires sufficient regulatory certainty to make long-term financing, procurement and delivery decisions with confidence.

X4. Taken together, these factors mean Watercare has only two practical sources of funding for investment: the revenue it is allowed to recover from customers and the debt we can raise against those revenues. Investment is expected to increase from approximately $1 billion in 2025 to around $1.6 billion per year by 2031. Since financial separation from Auckland Council, Watercare has established access to capital markets, raised approximately $1.5 billion of bonds, and expects bond issuance to exceed $8 billion by 2031 in order to fund investment and refinance the Auckland Council Transition Loan. Our capacity to fund the investment efficiently depends directly on the financial settings established through this framework.

The key issues for consideration

X5. The Commission's emerging views and Watercare's position differ on several foundational settings that together determine whether the framework is financeable and deliverable, as indicated by the table below.

Regulatory setting	Commission emerging view	Watercare position	Sensitivity
Cost of capital (including percentile)	5.40%	6.51%	~$100m-$140m per annum[1]
FFO/Net Debt target	9%-13%	~15%	~$60m-$65m per annum[2]
Net Debt/RAB target	Up to 75%	55%	~$110m-115m per annum[3]

X6. The detailed reasoning supporting Watercare's position is set out throughout this submission and in the accompanying Frontier Economics report. Collectively, these settings determine whether the first price-quality path provides sufficient financial resilience, investment capacity and regulatory certainty to support the efficient delivery of water services in Auckland.

Why this matters for Aucklanders

X7. If the regulatory framework does not provide sufficient financial capacity for Watercare, the consequence is not lower shareholder returns. The consequence is deferred infrastructure investment. In water infrastructure, deferred investment is rarely low cost. It generally results in higher costs later, alongside lower resilience and greater service risk in the meantime. More importantly, this risks negative health and economic outcomes.

X8. Watercare has recent experience of managing significant unforeseen events. Global events (Covid, Gulf Conflict), drought, severe weather and major asset failures have required immediate responses while continuing to deliver critical infrastructure programmes. These events demonstrate the real-world importance of maintaining financial resilience and sufficient capacity to absorb shocks while continuing to provide essential services.

X9. Many of Watercare's major projects will be delivered just as they are needed and cannot be paused without significant contractual, delivery and cost consequences. A framework that leaves insufficient capacity to respond to unexpected events and overly constrains capital delivery programmes will not reduce long-term costs for consumers; it will instead increase future costs, risk eroding the reliability and resilience of essential water services, and delay the delivery of necessary infrastructure.

X10. Affordability remains important. However, affordability should inform the pace at which revenue is recovered rather than the level of financial resilience required for an efficient water utility. A framework that suppresses investment or weakens financeability to reduce near-term prices is

[1] Based on the change in building blocks allowable revenue from increasing the weighted average cost of capital 1%, from 5.40% to 6.40% in PQP28, using the Commerce Commission's demonstration model.

[2] Based on the change in building blocks allowable revenue from increasing the FFO/debt by 1% in PQP28, using the Commerce Commission's demonstration model.

[3] Based on decreasing the maximum Net debt/RAB used to determine the initial financial regulatory asset base from 75% to 65% in the Commerce Commission's demonstration model.

unlikely to be more affordable over the long term if it leads to deferred renewals, higher future costs, reduced resilience or more disruptive future price increases.

In summary

X11. Watercare supports the Commission's objective of establishing a durable framework that promotes the long-term benefit of consumers and supports the application of established Part 4 principles where they are fit for purpose. Our submission is that those principles must be applied in a way that reflects Watercare's actual operating, financing and ownership circumstances.

X12. Watercare asks the Commission to:

a. Set the initial regulatory asset base at a level that supports the long-term investment programme rather than the minimum consistent with maintaining investment grade credit metrics.

b. Apply the benchmark A-/A3 credit rating consistently across the framework.

c. Set financeability metrics that provide genuine resilience rather than a bare minimum level of headroom.

d. Apply a cost of capital methodology that reflects Watercare's circumstances and efficient financing requirements.

e. Recognise that the cost of underinvestment in an essential service exceeds the cost of a modest over-estimate of the cost of capital.

f. Consult on the initial RAB, financeability and cost of capital before those decisions are embedded in the first price-quality path.

g. Provide risk management mechanisms that are timely, workable and capable of responding to material shocks, while recognising that such mechanisms are not a substitute for getting the core regulatory settings right from the outset.

h. We look forward to working constructively with the Commission to develop a first price-quality path that is financeable, deliverable and capable of supporting safe, reliable and resilient water and wastewater services for current and future Aucklanders.

INTRODUCTION

1. This submission responds to the Commerce Commission's (**Commission**) Price-Quality Path for Watercare – Emerging Views Paper (**Emerging Views**) and recommends refinements to the proposed regulatory settings where we consider changes are required to better promote the long-term benefit of consumers.

2. This submission is public. Alongside our submission, we have provided a report prepared by Frontier Economics.

3. We support the Commission's objective of establishing a durable price-quality (**PQ**) framework and agree with many aspects of the Emerging Views. However, we consider further refinement is required in several foundational areas, including financeability, the initial regulatory asset base (**RAB**), cost of capital, growth-funding mechanisms, risk allocation and regulatory process.

4. The matters addressed in this submission are interconnected and should be assessed as an integrated and internally consistent regulatory package. The initial RAB, cost of capital, financeability metrics, revenue recovery mechanisms and risk allocation framework collectively determine whether the first PQ path is workable in practice. We assess the Emerging Views against three related outcomes:

    4.1. Financial resilience – Watercare has sufficient capacity to absorb shocks, manage uncertainty, maintain investor confidence and preserve access to debt markets.

    4.2. Investment sufficiency – ensuring the framework enables the scale and timing of expenditure required to support growth, renew ageing infrastructure and improve resilience while delivering services at a quality that reflects consumer expectations.

    4.3. Regulatory certainty – providing confidence over key regulatory settings before Watercare commits to long-term financing, procurement and delivery decisions.

5. These outcomes are mutually reinforcing. A framework that does not support our financial resilience will ultimately constrain investment. A framework that does not support sufficient investment will not deliver the long-term outcomes expected by consumers. A framework that provides insufficient regulatory certainty risks delaying financing, procurement and delivery decisions at a time when Auckland's infrastructure requirements are increasing materially. The first PQ path will only be workable in practice if all three outcomes are achieved.

6. Consistent with these objectives, we have applied the following principles in assessing the Emerging Views and developing the recommendations set out later in this submission:

    6.1. **Consistency of financial assumptions**. Financeability, cost of capital and regulatory settings should be assessed using a consistent set of underlying assumptions.

    6.2. **Financial resilience should be assessed on a forward-looking basis.** Financeability metrics should provide sufficient headroom to absorb unforeseeable shocks and maintain efficient access to debt markets, rather than being calibrated to minimum thresholds.

    6.3. **Net debt/RAB should preserve balance-sheet capacity.** Assessment of leverage should recognise our inability to raise equity, substantial investment programme, and exposure to operational and delivery risk.

    6.4. **Timing mechanisms should not substitute for financeability.** Financeability targets should be established before cashflow timing is considered. Indexation, depreciation profiles, revenue

smoothing and customer contribution mechanisms can affect the timing of recovery, but they should not be used to compensate for underlying financeability settings that are insufficient.

6.5. **The initial RAB must support long-term financial sustainability.** We support the Commission's conditional preference for a physical initial RAB, provided it produces a financially sustainable outcome. If it does not, then the financial initial RAB, or an adjustment informed by it, should be used and calibrated to support long-term financeability outcomes.

6.6. **Cost of capital settings should reflect our circumstances and risk profile.** We recommend applying the standard CAPM, updating the comparator set, using a consistent approach to beta, leverage and benchmark credit rating, and applying at least the 65th percentile given the consequences of underinvestment in essential water and wastewater infrastructure.

6.7. **Growth funding mechanisms should recognise timing and uncertainty risks.** We support efficient recovery of growth-funded assets. However, Infrastructure Growth Charge (IGC) revenue is material, uncertain and timing-dependent, and a financeability reopener is needed where materially lower IGC receipts create financeability pressure.

6.8. **Key regulatory settings should be sufficiently developed before they are embedded in the first PQ path.** We recognise that some uncertainty is inherent in any regulatory regime. However, in the absence of upfront water-sector input methodologies, there remains a wide range of potential outcomes for the initial RAB, financeability and cost of capital. We therefore recommend targeted consultation on these foundational settings before they are incorporated into the first PQ path.

6.9. **Risk-management mechanisms should complement, not replace, core settings.** Reopeners, wash-ups and pass-through costs should operate as safeguards for exceptional or uncertain events, not as the primary means of correcting an insufficient price path.

7. Applying these principles leads to the recommendations summarised in Table 1. The recommendations should be assessed as an integrated package. We note, however, due to the limited time available to consider all matters covered in the Emerging Views, it has been necessary to reserve our position on certain topics – namely the proposed treatment of IGC revenue and alternative funding options such as IFF. Our consideration of these matters remains ongoing and will be shared with the Commission in due course.

Table 1 – Summary of recommendations

Reference	Recommendation
Financial sustainability	
R1	The benchmark A-/A3 credit rating should be applied consistently across the regulatory framework. If A-/A3 is used to estimate the debt premium, the initial RAB, revenue path, financeability tests and risk mechanisms should also support metrics consistent with that benchmark credit rating.
R2	It is important to ensure that the regulatory rules do not risk causing cash flow or credit rating issues. Watercare relies on funding from revenue and debt, we cannot get additional equity from our shareholder, therefore we need to have a sufficient buffer against shocks. This is not a nice-to-have. As required by the Local Government (Water Services) Act 2025[4] and acknowledged in the Emerging Views in paragraph 2.11, water service suppliers including Watercare must ensure the revenue and funding for providing water services is sufficient to sustain long-term investment in water services, while meeting all regulatory requirements.
R3	We recommend the Commission adopt a funds from operations (**FFO**)/net debt target of approximately 15**%**, with 10% treated as a minimum financeability floor rather than an efficient target. This is consistent with Moody's minimum threshold for an A-/A3 rated regulated water utility. This would provide Watercare with an adequate margin of safety against unanticipated events that could lead to financial distress. A target of 15% would also recognise Watercare's constrained financial flexibility and substantial investment programme. This responds to paragraph 4.54 of the Emerging Views.
R4	The target financeability metrics should be subject to technical consultation to develop an in-principle approach prior to the Watercare proposal being submitted. This would provide the certainty we require to continue with our current programme of work and financing arrangements. This responds to paragraph 4.27, 4.55 and 4.70 of the Emerging Views as well as the approach applied in the Commission's demonstration model.
R5	We agree that net debt/RAB is an important financeability metric. However, a 75% threshold would be consistent with a sub-investment grade credit rating under Moody's rating methodology for regulated water utilities. A threshold of 55% would, under Moody's rating methodology, be more consistent with an A-/A3 credit rating for a regulated water utility. A threshold of 55% would also better reflect Watercare's need to manage exposure to shocks without recourse to new equity, its significant investment programme, and its limited borrowing capacity. Frontier Economics independently reached a similar conclusion, recommending a 55% net debt/RAB threshold[5] as more consistent with the benchmark credit rating and the financeability requirements of a capital-intensive, equity-constrained business. This responds to paragraph 4.27 and 4.55 of the Emerging Views as well as the approach applied in the Commission's demonstration model.

[4] Local Government (Water Services) Act 2025, s 18(1)(b).

[5] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 3.1.2, page 48.

Reference	Recommendation
Setting the initial RAB	
R6	We support the Commission's preference for the physical initial RAB (Deemed Historical Cost) approach subject to a suitable level of asset information being available and the resulting revenue path (in expectation) generating sufficient regulated cash flows. Unlike the financial initial RAB, the physical initial RAB will reflect audited asset values and will be grounded in actual asset data. This responds to paragraph 4.33 of the Emerging Views.
R7	We acknowledge the Commission's view that we can propose an alternative initial RAB. Given the regulatory settings outlined in the Emerging Views, we expect that this will be necessary. However, our preference is to reach agreement on the key initial RAB settings before submitting our proposal, providing greater certainty and reducing the need to develop alternative scenarios. This responds to paragraph 4.44 of the Emerging Views.
R8	The decision on whether to index the RAB must consider financial sustainability, not simply just apply the approach taken for other industries. Frontier Economics recommends non indexation for a period of time to support financeability. This responds to paragraph 3.38.2 and 4.24 of the Emerging Views.
R9	The physical and financial initial RAB options need to be considered on a like-for-like basis in order to ensure the financeability targets aren't solely being met due to differences in depreciation and indexation. The Emerging Views, and demonstration model, compares the physical RAB with indexation applied and asset lives based on GAAP to a financial RAB with no indexation and a back solved asset life to meet minimum financeability metrics in PQP28. This responds to paragraph 4.28 and 4.29 of the Emerging Views.
Cost of capital	
R10	We agree with the Emerging Views that the weighted average cost of capital (**WACC**) estimate should include both the cost of debt and cost of equity based on a benchmark efficient firm. While Watercare cannot pay dividends to Auckland Council, the cost of equity is required to reflect the revenue required to maintain sufficient retained earnings to fund investment. Capital in the RAB continues to bear systematic risk regardless of ownership structure or equity restrictions. This responds to paragraph 5.8 of the Emerging Views.
R11	As Watercare is exempt from corporate tax, and prohibited from paying dividends, its owners cannot benefit from dividend imputation. Therefore, the Standard Capital Asset Pricing Model (**CAPM**) should be applied, rather than the Simplified Brennan-Lally CAPM (**SBL-CAPM**). As discussed by Frontier Economics, this will provide a better estimate of the opportunity cost of equity, given Watercare's tax status and restrictions on the payment of dividends. This responds to paragraph 5.20 of the Emerging Views.
R12	The same comparator set should be used to estimate the benchmark beta, leverage and credit rating, consistent with Frontier Economics' recommendation.[6] This will improve

[6] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.5.2.

Reference	Recommendation
	consistency across the WACC estimate and avoid the leverage anomaly. This would also be consistent with the Commission's established approach to other industries.
R13	The comparator set in the Emerging Views should be updated to filter: liquidity based on bid-ask spreads, country based on advanced and advance emerging economies and business activities using a broader approach. We recommend applying the approach outlined in Frontier Economics' report which strikes an appropriate balance between selecting comparable firms and reducing sampling error. This responds to paragraph 5.25-5.29 of the Emerging Views.
R14	We recommend the Commission apply at least the 65th WACC percentile. A midpoint WACC implicitly assumes the costs of over- and under-estimating the efficient cost of capital are equal, however this is not the case for the water sector. Water is at least as essential as electricity, and the Commission's own evidence indicates that water demand is no less essential. Watercare also faces a substantial investment programme to renew assets, support growth, improve resilience, and maintain service quality. This investment is necessary to remediate historical underinvestment. If the allowed return is set below the true cost of capital, the resulting underinvestment risk would impose material economic costs on consumers, at least the size of the costs the Commission has recognised for electricity networks. This responds to paragraph 5.44 of the Emerging Views.
R15	We agree that we should be allowed to propose a term credit spread differential allowance (**TCSD**) and have proposed a mechanism to ensure this is set appropriately given our developing debt book. This responds to paragraph 5.42 of the Emerging Views.
R16	We agree that an allowance for debt issuance cost of 0.20% must be provided. This is consistent with the Commission's standard allowance and provides a prudent allowance for efficient financing costs. This responds to paragraph 5.40 of the Emerging Views.
R17	Changes implemented to the cost of capital method in the Part 4 and Part 6 Input Methodologies (**IMs**), which are relevant to our unique circumstances, should, where possible, be incorporated into our regulatory settings. This responds to paragraph 5.58-5.61 of the Emerging Views.
R18	We acknowledge the Commission's view that we can propose alternative WACC settings alongside a scenario that includes the outcome of applying the Commission's recommended WACC settings (updated to reflect a contemporaneous risk-free rate and average debt premium). We expect this will be required given the regulatory settings in the Emerging Views. We would prefer to agree the required WACC settings ahead of submitting our proposal. This responds to paragraph 5.48-5.53 of the Emerging Views.
Process	
R19	We recommend that there is technical consultation on the initial RAB, cost of capital and financial sustainability. This responds to paragraph 5.54 of the Emerging Views.
R20	We require the Commission to make its final PQ decision by no later than 1st February 2028. Our Constitution requires us to provide a draft annual budget to our shareholder, typically by 1st March. For efficiency in reporting and analysis, we maintain consistency between all budgets, and this needs to continue. We also require sufficient lead time to

Reference	Recommendation
	flow through changes required by the determination, including governance approval of price changes, updating prices in systems with associated testing and assurance activities, and communicating changes to customers prior to the commencement of PQP28 on 1 July 2028. The period between this date and the price-quality path's commencement on 1 July 2028 is shorter than that allowed for the electricity sector.
R21	We agree with the Emerging Views that appropriate changes to our information disclosure (**ID**) requirements may require consultation. Where the Commission adopts rules for us that are intended to be similar to the IMs used in other regulated sectors, it should use the established IM wording unless there is a clear and specific reason to depart from it. Those IMs provide a long-established and tested framework, developed through multiple reviews, and should be the starting point in the absence of water-specific IMs. Any departure from the existing wording should be carefully considered and transparently justified as part of the PQ setting process. This will help preserve consistency, reduce uncertainty over interpretation, and avoid unintended changes to the operation of the PQ settings.
Quality standards	
R22	We agree with the Emerging Views requirement that we propose at least one quality standard for PQP28. We anticipate proposing additional quality measures for monitoring. This responds to paragraph 8.7 of the Emerging Views.
R23	We consider care should be taken to distinguish between measures suitable for an enforceable PQ quality standard and those better suited to monitoring, including under ID reporting. PQ standards should include one or more overarching measures of service performance that can support compliance assessment. More targeted measures, such as interruptions greater than 8 hours, are suited for supporting reporting through tools such as ID.
R24	We consider there are limits to Watercare's ability to define standards based on novel measures for PQP28. As well as signalling compliance in PQP28, learnings from quality standards set will likely drive the development of quality standards for future resets.
R25	We agree that our proposed quality standard will reference consumer feedback, however this will be limited to historical engagement and engagement through Auckland Council's Long-term Plan development. This responds to paragraphs 8.11 and 8.12 of the Emerging Views.
R26	We agree that there should be no financial or non-financial incentives on service quality for PQP28. This responds to paragraph 8.24 of the Emerging Views.
Revenue path and risk	
R27	We agree that the maximum allowable revenue (**MAR**) should be applied to forecast total allowable revenue. A single revenue cap should apply across both water and wastewater services. This responds to paragraph 6.20 and 6.30 of the Emerging Views.
R28	We agree that there should be no additional price controls that apply alongside the MAR. The Emerging Views proposes to exclude IGC price increase requirements as part of the

Reference	Recommendation
	PQ decision. We support this as a pragmatic approach to reducing complexity and allowing our current work on pricing to continue. This responds to paragraph 3.7 and 6.59 of the Emerging Views.
R29	We agree that there should be no tax building block. For consistency, the WACC estimate also needs to reflect our tax exempt status. This responds to paragraph 3.27 of the Emerging Views.
R30	We agree that there should be no additional financial incentives applied to expenditure and quality. Introducing bespoke incentive mechanisms at this point would add compliance cost and risk without clear evidence of benefit for consumers. This responds to paragraph 6.37 of the Emerging Views.
R31	We agree with the Emerging Views that reopeners should be clearly defined. We recommend adding a reopener for financeability to the current proposed reopeners (catastrophic events, legislative changes and error events). This responds to paragraph 6.45 and 7.47 of the Emerging Views.
R32	We agree that pass-through costs should be consistent with the approach taken in other industries. We recommend that, at a minimum, council rates, regulatory levies, and Fire and Emergency New Zealand (**FENZ**) levies should be included as pass-through costs. This responds to paragraph 6.44 of the Emerging Views.
R33	Wash-ups should include: truing up the forecast and actual initial RAB, continuation of the Charter wash-up, pass-through costs, the RAB at each reset, inflation, as well as under and over recovery of the MAR. This responds to paragraph 6.50 and 6.56 of the Emerging Views.
R34	There should be no limits applied to the wash-up account, accruals and drawdowns within PQP28. This responds to paragraph 6.51 of the Emerging Views.
R35	We may propose additional wash-ups and reopeners in our proposal.
Regulatory period	
R36	We agree that PQP28 should be a three-year period covering 2029-2031 (inclusive). This responds to paragraph 6.67 of the Emerging Views.
IGCs and Infrastructure Funding and Financing (IFF)	
R37	IGC revenues are subject to significant uncertainty due to the timing and scale of development activity. Material downside variance in IGC receipts could affect our cash flows and financeability during PQP28. This could be addressed via a targeted financeability reopener.
R38	We acknowledge that the regulatory treatment of projects funded through IFF arrangements should be determined. Although we do not yet have IFF arrangements in place, we are considering whether and how this mechanism might apply in practice. Accordingly, there are details to be determined which may influence the appropriate regulatory treatment.

Reference	Recommendation
Expenditure assessment and verification	
R39	We agree that, if verification is required for PQP28, it should be targeted and proportionate. This means focusing on areas of expenditure that are material, higher risk or subject to greater uncertainty, rather than requiring comprehensive verification across all aspects of the proposal. This responds to paragraph 9.2 of the Emerging Views.
R40	We accept the efficiency improvement objective and expenditure objective. These must be applied in a proportionate approach considering our current asset management maturity and Charter improvement plans. This responds to paragraph 7.8-7.13 of the Emerging Views.
R41	We support ongoing reporting on our Charter improvement plans in the current form for the duration of each plan. This responds to paragraph 7.29 and 7.33 of the Emerging Views.
R42	We agree that additional bespoke financial incentives mechanisms are not necessary for PQP28. This responds to paragraph 6.37 of the Emerging Views.

FINANCIAL SUSTAINABILITY

8. Watercare is not entering PQP28 from a steady state financeability position. Conservative levels of investment over past decades, together with continued population growth, mean Watercare must now substantially increase investment to renew ageing assets, provide for growth and improve resilience. Transitioning to a financial capital maintenance (**FCM**) model at this point creates particular financeability challenges because revenues that recover historical investment may not be sufficient to fund the step-up in new investment required, especially given that we cannot raise new equity. The regulatory framework therefore needs to provide more than minimum revenue sufficiency: it must enable us to fund a materially larger investment programme while maintaining sufficient financial resilience to withstand shocks and preserve an investment grade credit profile.

9. Financial resilience is therefore central to the design of our PQ path. We operate in an environment where shocks and forecast uncertainty can materially affect costs, asset performance, delivery programmes and financing requirements. A framework that provides only minimum sufficiency would leave little capacity to absorb these pressures and would likely result in the deferral of efficient investment, disruption to committed programmes and contracts, higher delivery costs, and greater future regulatory risk. Recent experience illustrates why we require sufficient financial capacity to manage uncertainty while continuing to deliver essential services. Examples include:

    9.1. Covid-19 increased delivery costs despite unchanged investment needs. Lockdowns suspended most non-essential construction for around five weeks, later restrictions reduced productivity, and supply-chain disruption increased the cost and lead times for critical materials. The cost implications were significant, for the Central Interceptor program alone **CI[ ]**. At that time the Central Interceptor was Watercare's single flagship program. Going forward, we will have multiple flagship programs simultaneously, amplifying the risk.

    9.2. Droughts require financial headroom to manage supply and asset risks in real time. In 2020, dam storage fell significantly, requiring us to shift to more resilient sources such as the Waikato River and Onehunga aquifer. Dry soil conditions can increase watermain breaks and leaks, both

of these increase operating expenses beyond the norm. **CI[ ]** project spend was deferred with business cases already approved, and we learnt that it is not possible to slow down in-flight projects quickly. The Waikato 50 project was accelerated because of the drought situation.

9.3. Severe rainfall can create immediate operational costs and longer-term resilience needs. Floods and landslides can cause major damage to critical facilities, as demonstrated by the 2023 Anniversary weekend floods, which damaged key infrastructure across the network. The damage from the floods resulted in **CI[ ]** of damage, whilst **CI[ ].** Saturated ground conditions contributed to the collapse of the Ōrākei Main Sewer, which required an emergency 400-metre bypass and resulted in significant overflows into the harbour. The total cost of the Ōrākei Main Sewer repairs alone is expected to be over $86 million.[7]

10. Unlike other regulated businesses, we cannot raise additional equity from our shareholders and we are reliant on internally generated cash flows and debt funding to finance investment – in this sense our customers provide our equity. It is therefore particularly important that the regulatory framework provides adequate headroom against unforeseen events so that we can react quickly without cash flow constraints or unnecessary pressure on credit rating metrics. Otherwise, we could be forced to defer investment, breach contractual commitments, incur significant additional costs, delay critical infrastructure projects and compromise service outcomes for customers. None of these outcomes would be consistent with supporting the Part 4 purpose. Given the scale and sequencing of our investment programme, many projects are delivered on a just-in-time basis and cannot be paused without substantial cost and delivery consequences.

11. The need for headroom is reinforced by the fact that several significant shocks and cost pressures have occurred within a relatively short period. This demonstrates that risks do not arise in isolation and highlights the importance of maintaining sufficient financial capacity to absorb multiple concurrent events while continuing to deliver critical investment efficiently.

12. Investor confidence is critical to our financeability. Since financial separation from Auckland Council in 2025, we have established access to debt capital markets and begun transitioning from short-term funding sources, including the $4 billion Auckland Council Transition Loan, revolving credit facilities and standby facilities, to a long-term bond financing strategy. We have already raised $1.5 billion in bonds and expect bond issuance to exceed $8 billion by 2031 to finance required investment and repay the Auckland Council Transition Loan. Given this material shift in the scale, tenor and composition of our debt portfolio, investors will require confidence that the regulatory framework provides sufficient cash flows for Watercare to maintain a strong credit rating that would allow efficient access to debt markets.

13. The Emerging Views notes that our financing constraint has eased since financial separation because our credit rating enables greater access to debt funding. While this is correct in principle, that borrowing capacity is not unconstrained. It depends on maintaining our current rating, including FFO/debt remaining consistently above 10%. The regulatory framework therefore needs to provide sufficient cash flow headroom to preserve borrowing capacity and maintain investor confidence. Efficient access to debt markets is not determined solely by whether Watercare remains investment grade, but by the resilience and stability of the credit rating metrics that support efficient long-term financing.

14. The Emerging Views Paper focuses on FFO/net debt and net debt/RAB. However, financeability assessments should consider the broader range of metrics used by credit rating agencies. This

[7] Watercare, Ōrākei Main Sewer rehabilitation: Stage two ramping up while stage one nears completion (accessed on 16/7/26), https://www.watercare.co.nz/home/about-us/latest-news-and-media/orakei-main-sewer-rehabilitation-stage-two-ramping-up-while-stage-one-nears-completion

would be consistent with the Commission's recent Default Price Path (**DPP**) 4 approach, where it considered a broader suite of metrics, including debt/EBITDA and FFO interest cover. For Watercare, a broader assessment would provide a more rounded view of financial sustainability and better reflect how rating agencies assess credit quality in practice. It would also help ensure that the PQ path supports not only minimum investment grade status, but the financial resilience needed to maintain efficient access to debt markets, absorb shocks and deliver the required investment programme.

Interpreting financeability metrics across credit rating agency methodologies

15. We note that the Emerging Views benchmark credit rating is expressed primarily using S&P terminology (A-), whereas our credit profile is assessed by Moody's. While the rating categories are broadly comparable, the two agencies apply different rating methodologies and place different emphasis on individual financeability metrics. We are rated by Moody's, so Moody's methodology is most relevant to an assessment of our financeability. Moody's places primary weight on FFO/debt as an indicator of standalone credit strength, and its rating methodology for regulated water utilities is detailed and clear.

The FFO/net debt target must support financial resilience

16. Consistent with the above, the FFO/net debt threshold should not be viewed solely as a credit rating metric. It is a cash flow resilience metric that reflects the level of financial capacity and management discipline necessary to deliver efficient expenditure and sustain long-term investment for the benefit of consumers. For Watercare, this metric is particularly important because we cannot rely on shareholder equity injections to restore financial metrics if cash flows are weaker than forecast. A threshold set too low may preserve short-term affordability but risks underinvestment, reduced resilience, financial distress and weaker incentives for efficiency. None of these outcomes would promote the long-term interests of consumers. In our case, the threshold should represent a minimum financeability floor that can be maintained through reasonably foreseeable operational, environmental and economic shocks while continuing to deliver essential services and investment.

17. The Emerging Views proposes a benchmark credit rating of A-/A3, which we support. An FFO/net debt ratio of 15% is consistent with an A-/A3 credit rating for a regulated water utility under Moody's rating methodology. Ensuring that we can expect to generate sufficient cash flows to maintain an FFO/net debt ratio of 15% (commensurate with the benchmark credit rating) would (as the Commission expresses it) provide us with an "adequate margin of safety… against the possibility that economic downturns or shocks can lead to financial distress."[8]

18. In assessing an appropriate FFO/net debt ratio, the Commission should consider a range of factors including business risk, financial flexibility, investment intensity, desired credit quality, efficiency incentives, resilience to shocks and customer affordability. Our business risk is elevated by exposure to weather events, asset failures, delivery risk and cost escalation, while financial flexibility is constrained by the absence of shareholder equity support. At the same time, we face one of the largest and most sustained infrastructure investment programmes in New Zealand with investment expected to increase to $1.6 billion per year by 2031 (from the 2025 level of $1 billion).[9]

[8] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at D.44.

[9] Watercare, *Annual Report 2025*, at page 42.

19. Taken together, these factors support an efficient FFO/debt of approximately 15%. The 15% ratio is at the low end of Moodys A-/A3 range (15%-25%) providing the resilience Watercare's circumstances demand. A ratio of 10% should be viewed as a minimum financeability floor, post risk adjustment, rather than an efficient target. Customer affordability remains an important consideration, but it does not alter the level of financial resilience required of an efficient benchmark utility; rather, it informs the pace at which the associated revenue requirement is recovered from customers. Only genuinely exceptional events should be expected to result in FFO/debt falling below 10%, with a subsequent pathway back to the target range.

20. An FFO/net debt target of 15% also supports an orderly transition into our first PQ path. For PQP28 we will need to move from an operating capability maintenance (**OCM**) to FCM based recovery which creates specific financeability challenges during a period of rapidly increasing investment and debt financing requirements. Under OCM the capital cost of replacing and renewing assets is recovered before projects start, through periodic asset revaluations, however, under FCM capital cost recovery is delayed until after projects are complete. The long-lived nature of our assets means that costs are recovered over very long horizons, and cash flows from the regulatory depreciation allowance can be low relative to the large debt obligations required to finance significant new investment.

21. The Emerging Views proposes a 9-13% FFO/net debt range.[10] In our view, the lower end of this range is difficult to reconcile with the Commission's own approach to financeability. The Emerging Views adopts an A-/A3 benchmark credit rating for estimating the debt premium, states that an A- rating provides an adequate margin of safety, and also indicates that a credit rating below the rating assumed for estimating the debt premium would indicate a financial sustainability concern. The lower end of the Emerging Views' target FFO/net debt range, 9%, is consistent with a sub-investment grade credit rating under Moody's rating methodology for regulated water utilities.

22. An FFO/net debt ratio of 10% would be consistent with a bare investment grade credit rating under Moody's methodology for regulated water utilities. However, the target FFO/net debt ratio should be chosen to provide meaningful headroom above minimum investment grade outcomes, rather than being calibrated close to them. This level of FFO/net debt does not provide the level of financial resilience required for our circumstances. Indeed, the Emerging Views makes clear that an A-/A3 benchmark credit rating (rather than a bare investment grade BBB-/Baa3) rating is what is required to ensure that we can weather shocks and other unanticipated events. Whilst the Emerging Views considers the forecasts from our Business Plan, there are several errors:

    22.1. Importantly, the 9% lower limit is below the 9.7–11.4% FFO/net debt range forecast in our public Business Plan[11] and therefore provides less headroom than our planning assumptions from 2024. Since the Business Plan was prepared, further work has refined our understanding of the minimum credit rating metrics required to maintain our target credit quality, confirmed the scale of investment required as planning horizons have rolled forward, and improved our expenditure forecasting capability. Collectively, this work points to a higher financeability requirement than was reflected in the Business Plan.

    22.2. The proposed lower bound is also difficult to reconcile with Moody's guidance for regulated water utilities and maintaining a resilient standalone credit rating. As noted above, the 9% threshold is consistent with a sub-investment grade rating under Moody's rating methodology

[10] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 4.53.

[11] Watercare, *Business Plan 2025 — 2034*, watercare_business_plan_2025_rev_pdf_ef56181d3e.pdf (accessed on 4 July 2026).

for regulated water utilities and therefore does not provide a prudent margin above downgrade thresholds.

22.3. More importantly, the lower end of the range risks treating minimum investment grade status as the relevant financeability benchmark. That is not consistent with our need to maintain efficient access to debt markets, comply with our obligation to maintain a standalone investment grade credit profile, and preserve sufficient headroom to absorb reasonably foreseeable shocks. It is also inconsistent with the benchmark credit rating adopted elsewhere within Emerging Views - as the Emerging Views emphasises, the benchmark credit rating must be "comfortably within an investment grade credit rating" rather than be a bare investment grade rating. [12]

22.4. The Emerging Views contains an internal consistency issue. For WACC purposes, the Commission adopts an A-/A3 benchmark credit rating to estimate the debt premium and states that an A- rating provides an adequate margin of safety with respect to water services. The Emerging Views also states that a credit rating below the rating assumed for estimating the debt premium would indicate a financial sustainability concern. If that benchmark credit rating is intended to have practical meaning beyond estimating the debt premium, the associated financeability metrics should be capable of supporting credit rating metrics consistent with that benchmark through realistic downside scenarios, rather than being calibrated close to minimum investment grade outcomes.

22.5. The Emerging Views notes that an A- credit rating "provides an adequate margin of safety with respect to water services",[13] which would be consistent with a target closer to 15%, however for financeability the Emerging Views does not appear to consider a safety margin is required.

23. Frontier Economics independently supports a more resilient financeability target, recommending a minimum FFO/net debt ratio of 15%. Frontier Economics considers this level to be consistent with the lower end of Moody's range for A- rated regulated water utilities and therefore broadly aligned with the benchmark A-/A3 credit profile adopted by the Commission for estimating the debt premium. This:

23.1. Supports an internally consistent framework in which financeability metrics, initial RAB settings and benchmark credit rating assumptions are aligned;

23.2. Provides sufficient headroom to absorb temporary shocks, forecasting error and short-term cash flow pressure; and

23.3. Supports compliance with our obligation to maintain a standalone investment grade credit rating.

24. The Commission's recent financeability decisions in DPP4 provide further support for a more resilient approach.[14] In that decision, the Commission adopted an FFO/net debt sense check exceeding 13% based on S&P's methodology and considered a 'strong' business risk profile and a financial risk profile above the boundary between Intermediate and Significant in order to achieve a bbb+ anchor rating. While we are not suggesting that the same benchmark should be applied directly, it is not clear why we should be assessed against a materially lower financeability range of 9-13%, given our substantially larger investment programme, increasing leverage, transition

[12] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 3.46.

[13] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at D.44.

[14] Commerce Commission, *EDB DPP4 Final decision Reasons paper Attachment G Financeability* (20 November 2024), at G54.

into economic regulation, greater revenue volatility than EDBs, and move from OCM to FCM-based revenue recovery.

A maximum net debt/RAB target of 55% would better support financial resilience

25. Net debt/RAB should be assessed as a balance sheet resilience metric, not simply as a maximum leverage tolerance. It measures the borrowing capacity and financial flexibility a prudent utility retains relative to its regulated asset base.

26. The Emerging Views proposes net debt/RAB range of 60-75%, with a maximum starting point of 75%.[15] In our view, a 75% threshold is too high to provide an appropriate financeability benchmark. The issue is not whether 75% may be compatible with retaining some form of investment grade rating in certain circumstances. The issue is whether it provides sufficient balance sheet resilience for our actual circumstances, including our inability to raise equity, substantial investment programme, exposure to shocks and need to maintain efficient access to debt markets.

27. The Emerging Views range appears to be drawn from Moody's Baa range for regulated energy networks, rather than from the methodology that Moody's applies to regulated water utilities which should be the appropriate basis for determining a leverage threshold for Watercare.[16] Our circumstances point to a lower leverage threshold. We face elevated business risk, significant growth and resilience investment, ageing assets, delivery risk, exposure to severe weather events and the transition into a new economic regulation regime. At the same time, our financial flexibility is materially constrained by the absence of shareholder capital support. These factors point to the imposition of a threshold that preserves meaningful balance sheet capacity, supports continued debt market access and provides resilience against future shocks and investment uncertainty. The Emerging Views 75% threshold is therefore materially too high. According to Moody's rating methodology for regulated water utilities, a 75% leverage ratio would fall within the Ba range and would therefore be consistent with a sub-investment grade rating.

28. If the Commission is concerned about circumstances where we fall below the credit rating assumed for estimating the debt premium, or experiences multiple downgrades affecting access to debt markets, the financeability framework should provide sufficient headroom to avoid those outcomes rather than operate close to them. A maximum threshold of 55% better aligns with our risk profile, investment requirements and limited financial flexibility while preserving balance sheet resilience and debt capacity. It would also be commensurate with the maximum credit rating for an A- rated regulated water utility under Moody's rating methodology.

Financeability settings should be established before cash flow timing is considered

29. The Emerging Views discusses the value of the initial RAB and a range of NPV-neutral cash flow reprofiling mechanisms, including changes to depreciation profiles, revenue smoothing and indexation. While these mechanisms can influence the timing of cost recovery, they serve a different purpose from financeability settings. The Commission should first determine the financeability outcomes required to support financial resilience, debt capacity and efficient access to debt markets. Only once those outcomes have been established should it consider whether cash flow timing mechanisms are required to achieve affordability, intergenerational equity or other policy objectives. Using cash flow timing mechanisms to compensate for

[15] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 4.53.

[16] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 3.1.2, page 45.

inadequate financeability settings risks obscuring an underlying financeability issue rather than addressing it.

30. The initial RAB is the primary mechanism through which long-term financeability is established because it determines the level of return and depreciation available to support investment, debt servicing and financial sustainability over time. NPV-neutral cash flow reprofiling can improve near-term cash flows by bringing forward revenue recovery, but it does not change the underlying level of recovery available to support financeability. If the initial RAB does not adequately reflect the capital invested and the level of financeability required, long-term return and depreciation will be insufficient, potentially creating ongoing financeability pressure. The Commission should therefore ensure it is not solving an underlying financeability issue by simply changing when revenue is recovered.

31. Any changes to cash flow timing should take account of our significant investment programme and be evaluated only after the required financeability outcomes have been determined. Frontier Economics identifies a customer capex contribution as one potential mechanism to support financeability, with customers effectively providing funding during periods of elevated investment and benefiting from lower charges when capital requirements reduce over time. Similarly, indexation should be viewed as a legitimate tool for managing the timing of cost recovery once financeability has been established, rather than a mechanism for creating financeability in the first place. Given Watercare's significant and growing capital programme, there is a strong case for considering a partially indexed or unindexed RAB, particularly over the period when we expect to deliver a large catch-up investment program over the first few regulatory periods under PQ regulation, where this supports financeability. However, the decision on whether, and to what extent, indexation should apply should follow the assessment of financeability requirements, rather than be determined as a matter of principle based solely on consistency with other sectors.

32. The Commission must strike an appropriate balance between ensuring the initial RAB reflects the efficient costs to be recovered over the long term and ensuring we are financially resilient. The Emerging Views discusses both the value of the initial RAB and NPV-neutral cash flow reprofiling (such as changing depreciation and revenue smoothing). NPV-neutral cash flow reprofiling can support short-term financeability by bringing forward revenue recovery, but it cannot compensate for an initial RAB that is set too low. If the initial RAB does not adequately reflect the capital invested and financeability required, long-term depreciation and return will be insufficient, potentially creating ongoing financeability issues. Therefore, the Commission should ensure it is not solving a low initial RAB by simply changing when revenue is recovered and the financial initial RAB should only be used if the physical initial RAB does not provide sufficient value.

33. Indexation should also be considered as part of any cash flow reprofiling. The Commission has previously recognised that indexation materially backloads cost recovery and that reducing, or removing, indexation can improve cashflows during periods of elevated investment while remaining consistent with FCM. Given our significant and growing capital programme, there is a strong case for considering a partially indexed or unindexed RAB where this would improve financeability. While this would reduce inflation protection, the Commission should carefully balance that trade-off against the need to maintain efficient access to capital and support the timely delivery of essential infrastructure investment.

SETTING THE INITIAL RAB

34. The initial RAB is the most material foundational input for PQP28 because it determines how historical investment is recognised and recovered over time, and because it will influence prices, financeability and regulatory returns across multiple regulatory periods.

35. We support the Commission's objective of setting an initial RAB that promotes the long-term benefit of consumers and supports efficient investment. In assessing the appropriate balance, the Commission should recognise that there is no risk of excessive profits because we are wholly owned by Auckland Council and cannot distribute profits to shareholders. The greater risk is that an initial RAB set too low could undermine our ability to finance and deliver the $15.2 billion investment programme required over the next decade.

36. The initial RAB should not be set with a view to minimising near-term prices at the expense of financeability – this is key to maintaining investment and revenue sufficiency. It should produce a revenue path that allows for us to service debt, maintain an investment grade credit rating, and continue investing in essential infrastructure, while ensuring consumers benefit from efficient investment.

37. We acknowledge the Commission's view that we can propose an alternative initial RAB.[17] Given the regulatory settings in the Emerging Views, we expect that will be necessary. However, our preference would be to agree the initial RAB settings before the proposal is submitted, to provide greater certainty.

The physical initial RAB should be used – subject to it providing a financially sustainable outcome

38. We support the Commission's conditional preference for the physical initial RAB option. This approach is conceptually consistent with the building blocks model (**BBM**) because it seeks to identify the historical capital invested in the RAB and derive the return of and on capital consistent with that. It also provides an appropriate foundation for rolling forward the RAB over the expected service lives of the assets used to provide regulated services to consumers. Further, the physical RAB is more transparent than the financial RAB, as stakeholders can trace the opening value to audited historical information, including asset additions, depreciation, disposals, capital contributions and vested assets.

39. We accept that the Commission must be satisfied that the records required to roll forward the 2011 asset values to 2028 are sufficiently reliable and capable of practical application. However, a pragmatic approach is required. While historical records may not be perfect, the physical RAB approach is grounded in substantially richer asset information than can be provided by a financial RAB. We are committed to working constructively with the Commission to reconcile the relevant asset records and address any data limitations as part of this process.

40. We agree that the financial initial RAB option is capable of supporting financeability and may be a reasonable fallback if the physical option cannot be implemented reliably. However, a physical initial RAB that achieves the same long-term value and financeability requirements, even if the information is imperfect, is better than a financial initial RAB. Accordingly, a financial initial RAB may be adopted where the physical initial RAB value is too low to support financial sustainable outcomes.

41. A financial initial RAB based on debt, an equity buffer and a modelled asset life is highly sensitive to a few critical assumptions. This is already evident in the Commission's demonstration model and care needs to be applied to ensure the settings are enduring and support long term sustainability outcomes.

[17] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 4.44.

The values in the physical initial RAB are more transparent than the alternative

42. The physical initial RAB, including the integration value, provides a more transparent foundation for the initial RAB than the financial RAB alternative. The integration value is based on audited asset records established through the Auckland local government reorganisation and reflects the actual water and wastewater assets vested to us under a legislatively prescribed process. As such, it is grounded in observable asset information and historical investment rather than assumptions about future expenditure, financing requirements, asset lives and long-term cash flows. While the integration value may be subject to some limitations inherent in historical records, those limitations are capable of being tested. The integration value therefore provides an objective, evidence-based and transparent starting point for establishing the initial RAB, promoting regulatory certainty and consistency with FCM.[18]

Financeability must be considered before indexing the RAB

43. In principle we support having appropriate inflation protection for the physical RAB (whether that's through full or partial indexation), however, whether the RAB should be indexed should be dependent on financial sustainability, not simply on applying the approach taken for other industries.

44. The Emerging Views proposes indexing the physical initial RAB (but not a financial initial RAB), as well as additions to the RAB, on the basis that it is consistent with the regulatory treatment applied in other sectors.[19] Indexing the RAB involves adding a Consumer Price Index (**CPI**) adjustment to the RAB and offsetting that adjustment by removing it from the revenue cap in any given year. This results in a significant amount of capital recovery (and therefore revenue and cash flows) being shifted to later years, compared to where no indexation is applied, since the CPI adjustments applied to the RAB are recovered via depreciation over a long timeframe. This can result in insufficient cash flows where significant investment is required.

45. Our investment in the network is expected to increase significantly prior to the start of PQP28 and throughout it – with capital expenditure forecast to exceed $1.5b per year by 2029. As such, the Commission must consider whether the resulting cash flows are sufficient before committing to indexation as the resulting shift in revenue recovery to outer years could be difficult to offset via other means, such as depreciation and asset life adjustments. This is not a new issue, the Commission previously decided not to index Transpower's RAB to ensure Transpower had sufficient cash flows while making significant catch-up investments.

46. The decision to index the RAB is not binary and may involve partial indexation. There is a strong case for not indexing the debt-funded portion of the RAB.[20] This reflects the fact that debt obligations are typically in nominal terms, meaning debt servicing costs are fixed in nominal dollars and do not increase with inflation. In these circumstances, indexing the debt-funded portion of the RAB can defer cash flows without providing any corresponding benefit in meeting debt obligations. The key financeability consideration is therefore ensuring sufficient nominal cash flows are available to service debt as it falls due, rather than preserving the real value of capital associated with debt financing.

---

[18] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 4.24.

[19] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 3.37.

[20] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at footnote 88.

The financial RAB should be consistent with long-term financial sustainability

47. If the Commission ultimately adopts a financial initial RAB (or an adjustment to the physical initial RAB based on it), the resulting revenue path should deliver a level of long-term financial sustainability that is at least comparable to that achieved under the physical initial RAB. A financial RAB that provides weaker financeability outcomes would increase the likelihood of future interventions to maintain revenue, cash flow, and investment sufficiency. Establishing a financially sustainable position from the outset will promote regulatory certainty, reduce the need for ongoing recalibration, and better support long-term investment planning. Accordingly, our expectation is that a financial RAB would only be adopted if the physical RAB was too low, and a higher initial RAB was required to generate sufficient cash flows to support our financial resilience.

48. As a starting point, the physical initial RAB and financial initial RAB methods should be evaluated on a like-for-like basis. The Emerging Views notes that the financial initial RAB is not intended to reflect the financial capital invested in Watercare to date[21] and that the remaining asset life does not need to reflect the lives of the physical assets.[22] While this flexibility allows the financial RAB to be calibrated to achieve particular revenue and cash flow outcomes, any comparison with the physical RAB should isolate the effect of the valuation methodology itself rather than differences in depreciation or indexation assumptions.

49. At present, the two approaches are not directly comparable. The financial RAB is assumed to have a single 35-year asset life, based on goal seeking,[23] and is not indexed for inflation, whereas the physical RAB is indexed and is based on materially longer asset lives, including an assumed 40-year average asset life. These assumptions accelerate capital recovery under the financial RAB and result in higher near-term cash flows.

50. If the Commission focuses only on whether those near-term cash flows meet minimum financeability metrics, without taking a longer-term view of real financial capital maintenance, it risks creating unintended consequences. In particular, a lower financial initial RAB may appear sufficient during PQP28 but could leave us with insufficient long-run depreciation and return to fund the replacement of existing assets, maintain resilience and support future investment. That would increase the likelihood of future financeability pressures, more disruptive price adjustments, or the need for further regulatory intervention. The Commission should therefore assess the financial and physical RAB options over the long term, rather than treating a short-term improvement in cash flow as evidence of sustainability.

51. If the physical initial RAB does not provide sufficient value to support long-term cost recovery and financeability, an adjustment informed by the financial initial RAB should be added to the physical initial RAB as a notional asset. This would be preferable to replacing the physical initial RAB with a standalone financial RAB, as it retains the link between the RAB and the underlying assets while addressing any financeability gap.

52. However, if the Commission chooses to solely use the financial initial RAB, then it can be allocated across the assets in the physical RAB to preserve the remaining asset life and service potential profile of the assets which are physically in use and providing water services to our

[21] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 4.26.

[22] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 4.28.

[23] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 4.64.

customers. The recovery of this value over the remaining service profile helps support financeability over the remaining life of the asset, consistent with lifetime depreciation.

53. The Emerging Views estimate of the financial initial RAB is also based on financeability targets that are too low. Frontier Economics' review of the Commission's demonstration model shows that, if the financial initial RAB were calibrated using Frontier Economics' recommended financeability metrics of 15% FFO/net debt and 55% debt/RAB, the resulting value would be approximately $12 billion. This is broadly consistent with the Emerging Views estimate of the physical initial RAB and confirms that the current estimate of the financial initial RAB is understated.

COST OF CAPITAL

54. The financeability, initial RAB and cost of capital settings should not be considered independently. Together they determine the revenue available to support investment, financeability and long-term financial sustainability. A framework that adopts prudent financeability metrics but understates the cost of capital, or vice versa, will ultimately undermine investment sufficiency and financial resilience.

55. The Emerging Views correctly recognises that the WACC should be estimated using a benchmark efficient-firm approach as a starting point, consistent with other Part 4 sectors and Part 6.[24] However, the objective should not be to replicate the model used for investor-owned utilities without modification, but to ensure that the resulting allowance promote efficient investment and the long-term benefit of consumers in the context of our operating model. On that basis, we have asked Frontier Economics to review the Commission's proposed approach and recommend settings for WACC and financeability that better reflect our efficient cost of capital.

56. Based on Frontier Economics' review, we recommend the following changes to Emerging Views cost of capital settings:

56.1. The standard CAPM should apply, rather than the SBL-CAPM;

56.2. The same comparator set must be used to estimate the beta, benchmark leverage and benchmark leverage;

56.3. The liquidity filter for the comparator set should be updated to use bid-ask spreads;

56.4. The country filter for the comparator set should be updated to include advanced emerging economies;

56.5. The Commission should broaden its filter on business activities; and

56.6. At a minimum, the 65th WACC percentile should be used, rather than the mid-point.

57. The sum of the improvements recommended by Frontier Economics result in a WACC estimate of 6.51%,[25] compared to the Emerging Views estimate of 5.40%.[26]

---

[24] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 5.8.

[25] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at Table 13.

[26] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at table 5.1.

The Commission should apply the standard CAPM, rather than the SBL-CAPM

58. As Frontier Economics recommend,[27] the Commission should use the standard capital asset pricing model (**CAPM**), not the Simplified Brennan-Lally CAPM (**SBL-CAPM**),[28] to estimate our cost of capital.

59. The SBL-CAPM reduces the required return on equity to reflect the value of imputation credits to investors. However, this adjustment is not appropriate for us because we are tax exempt, do not generate imputation credits, and cannot pay dividends. Consequently, our shareholder receives no imputation benefit. Applying the SBL-CAPM would therefore understate the opportunity cost of equity and fail to promote efficient investment.

The comparator set should be updated to provide a more representative sample

60. The comparator set should be selected using the Commission's established approach, but with updated liquidity, country and business activity filters that reflect Frontier Economics' recommendations. These updates strike a balance between selecting similar companies and providing an enduring representative sample. Our recommendations are below:

    60.1. The liquidity filter should use bid-ask spreads: the Emerging Views proposes to filter for stock illiquidity by excluding companies with a market cap less than $100 million USD,[29] however this is inconsistent with the Commission's method for other Part 4 regulated sectors and Part 6 where the Commission uses bid-ask spreads.[30] Using the method used in the 2023 IM review suggests that Artesian Resources Corporation where should be excluded.

    60.2. The country filter should be less restrictive: we agree with Frontier Economics' recommendation that the comparator set should be expanded to include firms operating in "advanced emerging" markets and should not exclude US-based firms.[31] The Emerging Views proposes limiting the sample to companies listed in equity markets classified as "developed".[32] However, this screen may unnecessarily reduce the size of the comparator set and exclude firms that are otherwise highly relevant to the assessment of water utility risk. On balance, we consider the trade-off between selecting the most comparable firms and maintaining a sufficiently large sample to reduce sampling error is better achieved by adopting Frontier Economics' sample. This would increase the robustness of the empirical analysis while still retaining an appropriate focus on risk faced by water utilities.

    60.3. Both Guangdong Investment Limited and Essential Utilities Inc should be included in the comparator set. Guangdong Investment derives more than 75% of its revenue from water-related activities, making it a highly relevant comparator for assessing the risks of water utilities. Similarly, Essential Utilities derives more than half of its revenue from water-related activities, with the remainder coming from other utility activities. Given the predominance of utility

---

[27] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.3.2.

[28] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 5.20.

[29] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at D.12.

[30] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.4.2, page 16.

[31] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.4.2, page 17.

[32] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at D.12.

revenues in both businesses, excluding these firms would unnecessarily narrow the comparator set.

The asset beta estimate should use the entire comparator set

61. We recommend using Frontier Economics' comparator set to estimate the asset beta. Although the Emerging Views identifies a 10-firm sample,[33] it appears to only use three UK firms when selecting its point estimate.[34] That approach is inconsistent with the Commission's established practice, which is to average beta estimates across the entire comparator set. Based on Frontier Economics' alternative sample and estimates, an asset beta of 0.41 is more appropriate for us.[35]

The benchmark leverage estimate should use a consistent comparator set

62. The Emerging Views proposes leverage of 35% - inconsistent with its beta reasoning.[36] The Emerging Views uses the full 10-firm sample to estimate leverage but appears to rely on the three UK firms to estimate beta. That is not consistent with the Commission's established approach of estimating asset beta and notional leverage together from the same comparator set, in order to avoid the leverage anomaly. We recommend using the same comparator set for both beta and leverage. Applying this approach to Frontier Economics' proposed sample produces a benchmark leverage estimate of 33%.

The benchmark credit rating estimate should use a consistent comparator set

63. We broadly support the Commission's established approach of specifying a benchmark credit rating for estimating the debt premium. However, we recommend using Frontier Economics' comparator set, which in this instance produces the same A- benchmark credit rating as the Emerging Views.[37]

64. However, as set out above, we note that an A- benchmark[38] rating has implications beyond the debt premium. If the Commission concludes that a benchmark efficient water business should be comfortably investment grade, it should set the initial RAB, revenue path and financeability tests so that a benchmark efficient firm can maintain credit rating metrics consistent with that rating. A framework that sets the cost of debt using A- but tests financeability only against bare investment grade thresholds would not be internally consistent.

65. As such, the equity buffer applied to the financial initial RAB should also be more consistent with the benchmark credit rating. In our view, an equity buffer closer to 55%, as recommended by Frontier Economics,[39] would better align with the benchmark credit rating assumption, provide

[33] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at table D.1.

[34] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at D.24 and

Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.4.2, page 23.

[35] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.4.2, page 24.

[36] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.6.2.

[37] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.7.2, page 32.

[38] We would expect the benchmark credit rating would support a baseline credit assessment higher than the minimum required for an investment grade rating.

[39] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 3.1.2, page 48.

greater resilience to forecast uncertainty, and improve consistency between the Commission's financeability assessment and the credit quality it expects a benchmark efficient supplier to maintain.

The 65th percentile should be used to estimate the WACC

66. We recommend the Commission apply at least the 65th WACC percentile, rather than the midpoint proposed in the Emerging Views,[40] given that water services are at least as much of a necessity as electricity and therefore the cost to consumers of underinvestment is at least as great.

67. As a lifeline utility required by 1.7 million people, it is common sense that the cost of underinvestment in our water and wastewater infrastructure is high. Frontier Economics note that the Emerging Views analysis indicates that water services have a lower income elasticity of demand and therefore are at least as much of a necessity for consumers as electricity.[41]

68. As Frontier Economics notes, the Emerging Views does not appear to consider the risk of underinvestment to be materially lower for us than for other regulated sectors.[42] However, it proposes using the midpoint estimate for the WACC on the assumption that the WACC has less of an influence on investment levels, compared to other regulated businesses, and that there are other mechanisms to mitigate the risk of underinvestment.[43] We respond to these below:

68.1. In response to the concern that a WACC uplift is a blunt instrument for addressing the risk of underinvestment, Frontier Economics considers that the alternative mechanisms, such as disclosures and cash flow reprofiling, proposed in the Emerging Views do not address the fundamental issue the WACC percentile is intended to solve - when the allowed return is below the true cost of capital investment is uneconomic.

68.2. The Emerging Views suggests that financeability concerns could be addressed through reprofiling of cash flows.[44] However reprofiling cash flows addresses a different issue, arising from the timing of regulated cash flows, not the risk of underinvestment that arises when the allowed return is below the true WACC. In those circumstances, there is an incentive to underinvest because the regulatory allowance is insufficient to support real FCM.

68.3. The Emerging Views argues that underinvestment could occur at different points across the supply chain and reporting requirements would provide a more targeted means of identifying any issues.[45] However, identifying where underinvestment occurs is not the same as addressing its cause. The fundamental issue is that an incentive to underinvest is created when the allowed return is below the true cost of capital and reporting does not address cause of underinvestment.[46]

---

[40] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 5.45.

[41] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.9.2, page 36,

[42] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.9.2, page 37,

[43] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at D.74.

[44] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at D.90.

[45] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at D88-D89.

[46] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.9.2, page 37.

68.4. The Emerging Views appears to place weight on not having empirical evidence of the cost to consumers of a water or wastewater outage.[47] However, we are entering a new regulatory regime, and so it is unsurprising that the Commission does not have evidence available. The absence of evidence is therefore due to the newness of the regime to the water sector, not evidence that the risk of underinvestment is immaterial. To resolve this, the Commission should consider evidence from overseas water utilities and comparable industries rather than risk setting an inefficiently low cost of capital, which in turn may disincentivise prudent and efficient investment valued by consumers.

69. Regulated electricity businesses are also subject to reporting and disclosure requirements, and the Commission has regulatory tools available to address their financeability. Yet the Commission has previously concluded that these mechanisms are not a substitute for a WACC percentile uplift in the electricity sector because they do not address the underlying risk that the allowed return may be set below the true cost of capital. It is unclear why the existence of these mechanisms supports a different conclusion for us, particularly given the Commission's acknowledgement of the significant investment programme required to maintain and expand our network.

We agree that a prudent and efficient TCSD should apply to Watercare

70. We support the Commission's proposal to allow a term credit spread differential (**TCSD**) allowance where we have a debt portfolio with a weighted average original tenor above five years. Long-lived water infrastructure is efficiently financed with debt tenors that reduce refinancing risk and better align financing with asset lives.

71. We recommend that the Commission assess our eligibility for a TCSD allowance based on our forecast debt portfolio over PQP28 (with the assessment undertaken no earlier than 30 June 2027) and excluding the Auckland Council transitional loan. This approach reflects our financing strategy and recognises that we only financially separated from Auckland Council last year.

72. Unlike other regulated utilities subject to Part 4 or Part 6[48] regulation, we have only been financially independent from Auckland Council since 2025 and are therefore in a transition period establishing a standalone debt portfolio. As a result, our current weighted average debt tenor is influenced by shorter-dated transitional borrowing arrangements that were necessary to support financing immediately following separation. In particular, the Auckland Council Transitional Loan has a five-year tenor but is a temporary arrangement and is not representative of our target long-term debt portfolio. Excluding this loan, our current weighted average debt tenor exceeds six years and is expected to increase as we continue to issue longer-dated debt. This change is consistent with prudent and efficient debt management for businesses with long-life assets and aligns more closely with Auckland Council's debt portfolio, which we estimate has a weighted average tenor of more than nine years.

73. A TCSD allowance is consistent with efficient debt management. Frontier Economics notes that Australian water and infrastructure regulators typically adopt a 10-year benchmark debt tenor, recognising the benefits of long-term financing for infrastructure assets. At a minimum, the Commission should retain the TCSD as a separate building block and apply it where we

[47] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at D.72-73.

[48] Telecommunications Act 2001, Part 6.

demonstrate qualifying long-term debt. Based on a seven-year tenor, Frontier Economics estimates a TCSD allowance of 0.11%.[49]

Process for determining the WACC

74. The Commission should determine our WACC through a transparent, consultative process that recognises the absence of water-specific IMs and the importance of the first PQP decision. As discussed below, given the material difference in estimates, a targeted consultation on WACC is required to provide additional certainty over the cost of capital parameters applied to our proposal. It would not be reasonable to decline necessary adjustments on the basis that there is insufficient time before 2028.

75. We acknowledge the Commission's view that we can submit alternative WACC proposals alongside a scenario based on the Commission's preferred WACC settings, updated for a contemporaneous risk-free rate and average debt premium.[50] Given the Commission's emerging views, we expect this may be necessary. However, our strong preference is for the key WACC parameters to be resolved before proposal submission, providing greater certainty and reducing the need to develop multiple scenarios.

PROCESS

There needs to be additional consultation on key matters

76. In the absence of upfront IMs,[51] it is critical that stakeholders have a meaningful opportunity to test key regulatory assumptions before they are embedded in our first PQ path. As the inaugural regulatory process for both Watercare and the wider water sector, decisions on the initial RAB, financeability and cost of capital will establish important precedents for future regulation.

77. We recommend targeted consultation on these matters as early as possible, ideally before we submit our proposal. Without greater clarity on the foundational settings, we will need to develop and submit multiple proposal scenarios in parallel which significantly increases complexity, cost and delivery risk. This is particularly challenging given the short time available to prepare the proposal and the absence of settled rules. Foundational settings will directly affect our expenditure plans, forecast revenues, customer prices and financing assumptions. If the proposal is prepared on one set of assumptions but the Commission adopts materially different assumptions in its draft decision, there will be limited time to reassess expenditure, financing and customer impacts before the final determination.

78. This is particularly relevant given that we will need to make significant capital investment commitments well before the final determination. As a result, the absence of confirmed timely technical consultations risks constraining the effectiveness of the propose/respond model and reducing stakeholders' ability to meaningfully test alternative views before key decisions are made.

79. Additional consultation is particularly important given the material differences between Watercare and the Emerging Views on the initial RAB, financeability and the cost of capital. These

[49] Frontier Economics, *WACC and financeability for PQP regulation of Watercare* (23 July 2026), at section 2.8.2, page 32.

[50] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 5.48-5.53.

[51] Watercare Services Limited, *Submission to the Commerce Commission on Price-Quality Path for Watercare – Approach Paper,* (5 February 2026), at 17-20.

decisions affect revenue sufficiency, investment incentives and financial sustainability, and should be tested through a formal technical process before being confirmed. As set out above, key differences include:

79.1. Initial RAB: the Emerging Views indicative estimates range from $8 billion for the lower financial initial RAB estimate to $11 billion for the higher physical initial RAB estimate;

79.2. WACC: Frontier Economics calculates a Vanilla WACC of 6.51%, compared with the Emerging Views estimate of 5.40%, a difference of more than one percentage point; and

79.3. Financeability: the Emerging Views proposes a 9–13% FFO/Net debt range, compared with our proposed ~ 15% target.

80. We are also concerned that the current process may inadvertently create a degree of path dependency on the Emerging Views. Without further structured opportunity for consultation and challenge before draft decisions are reached, there is a risk that preliminary positions become increasingly difficult to revisit as subsequent analysis and decisions build upon them. Dedicated technical consultation prior to our proposal submission would reduce this risk and provide greater confidence that the regulatory framework ultimately adopted best promotes the Part 4 purpose and the long-term benefit of consumers. This is particularly relevant given that we will need to make significant capital investment commitments well before the final determination.

81. We are committed to working constructively with the Commission to help ensure that the resulting regulatory framework and price path are fit for purpose. However, the process must provide sufficient certainty to ensure that we are not constrained in our ability to progress investments needed for consumers during the transition period to enduring economic regulation.

The final PQ determination should be made by February 2028

82. A final determination should be made by 1st February 2028. The Emerging Views indicates that the final decision for PQP28 may be issued at any point between March and June 2028,[52] which creates additional risk for us.

83. The first risk relates to maintaining consistency of budgets. With the Council annual budget typically due on the 1st of March, even the 1st of February will be a very compressed timeframe to maintain the efficiency gains we have made in analysis and reporting by aligning our submission to the Council budgeting process with our internal budget position. Secondly, the Board needs to sign off price changes in April, and we will require significant preparatory work on receipt of the determination before this decision can be put to our Board. This process cannot be delayed as this time is needed to process and test the changes in our billing system and prepare customer communications before the commencement of PQP28 on 1 July 2028.

ID and IM consistency

84. The Commission has indicated that once it has made a decision on the appropriate regulatory accounting basis underpinning our PQP, it will consult on amendments to our ID requirements to implement the same accounting basis for its regulatory reporting. We agree that it may be appropriate to make changes to our ID requirements as a result of the Commission's PQ decisions. While the same regulatory accounting basis should underpin PQ and ID regulation, ID settings can be updated to reflect the more detailed prescription of PQ decisions.

---

[52] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 1.6.

85. Where the Commission adopts rules for Watercare that are intended to be similar to the IMs used in other regulated sectors, it should use the established IM wording unless there is a clear and specific reason to depart from it. Those IMs provide a long-established and tested framework, developed through multiple reviews, and should be the starting point in the absence of water-specific IMs. Any departure from the existing wording should be carefully considered and transparently justified as part of the PQ setting process. This will help preserve consistency, reduce interpretive uncertainty, and avoid unintended changes to the operation of the PQ settings.

There needs to be sufficient time between draft and final decisions to allow for modelling updates

86. There will need to be sufficient time between the draft and final decisions to allow for updates to key regulatory parameters and forecasts. Our proposal will be prepared using information available during 2026, so several important inputs may need to be refreshed before the final decision in 2028. In particular, updates to the WACC, initial RAB, inflation and cost escalation assumptions, TCSD, and other core regulatory parameters will be required. There may also be a case for limited updates to IGC, opex and capex forecasts where these are materially affected by the Commission's draft decision, or where financial information is materially updated. Allowing a structured update process will reduce the risk of the determination being based on outdated information.

QUALITY STANDARDS

87. We agree with the Emerging Views requirement that we propose at least one quality standard. We anticipate proposing additional quality measures for monitoring, reflecting that we operate two networks.

88. We consider care should be taken to distinguish between measures suitable for an enforceable PQ quality standard and those better suited to monitoring and disclosure. The role of PQ quality standards is to identify one or more overarching measures of service performance that can support compliance assessment. More targeted measures may be useful for supporting reporting through tools such as Information Disclosure because they show specific customer impacts, but they do not provide a complete view of overall service performance.

89. For the purposes of our PQP28 proposal, we intend to include core network wide measure(s) focused on compliance consistent with no material deterioration in network service standards.

90. While this will require some review of existing measures and feedback received on them, we anticipate a targeted review of the most relevant performance measures we currently disclose under the Charter, other regulation or propose to disclose in time under ID. We consider this type of review is best suited to an ID review.

91. With only a short period of time available for preparation of our quality proposals, there are limits to our ability to define standards based on novel measures. PQ quality standards need to be based on clear definitions, reliable historical time series and auditable calculations and a compliance design that can distinguish a material deviation from normal performance in order to signal systemic rather than ad hoc performance variations. This will take time to establish. Development of standards has taken multiple resets and reviews for other sectors. Learnings from initial quality standards used in PQP28 will likely drive development of quality standards for future resets.

92. We agree that our proposed quality standards will reference consumer feedback, however given time available, this will be limited to historical engagement and engagement through our WSS development.

93. We agree that there should be no financial or non-financial incentives on service quality for PQP28. We consider inclusion of quality standard(s) in the PQ will already provide incentives for us in this area. As with expenditure incentives, we think formal quality incentive mechanisms are more likely to reward or penalise forecasting error — arising from uncertainty or immature processes — rather than genuine improvements in quality. Additional incentive mechanisms will also 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.

REVENUE PATH AND RISK

94. Overall, we support a pragmatic first PQP that is fit-for-purpose, proportionate, and capable of being implemented efficiently. We agree with many of the Commission's emerging views, but consider that some mechanisms—particularly reopeners, pass-through costs, and the transition of existing wash-up balances—need to be specified more clearly and designed to operate in a timely and workable way.

95. We broadly support the Emerging Views approach to allocate risk in a way that is broadly consistent with the Commission's approach to electricity distribution businesses and Transpower. In applying that framework, the Commission should recognise that we are continuing to build the systems, processes and capabilities required to operate effectively under a new economic regulatory regime. This transition should be reflected in how regulatory risks are allocated and managed.

The regulatory period should be three years

96. We agree with the Emerging Views preference for a three-year regulatory period for PQP28.[53] A three-year period appropriately reflects the early stage of the water regulatory regime, the scale of change from the Charter to Part 4 regulation and provides an opportunity to assess how the first PQP is operating. A longer initial period would increase the risk of locking in implementation issues before the regime has matured.

A single revenue cap covering regulated water and wastewater services is preferred

97. We support the emerging view that PQP28 should use a revenue-cap excluding IGC revenues.[54] A revenue cap is preferable to a weighted average price cap because it provides revenue certainty while allowing prices to adjust over time where actual demand differs from forecast demand. This is particularly important for us because consumption can vary materially due to weather and climate conditions, drought response, and changes in customer behaviour. Additionally, separate revenue caps for water and wastewater would add complexity without a clear consumer benefit.

---

[53] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 6.67.

[54] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 6.20.

98. We also support the view that PQP28 should not include minimum price or revenue limits. Pricing reform, including the treatment of IGCs, should be progressed through the current pricing work, rather than through additional price controls in the first PQP.

No additional financial incentives should be applied in PQP28

99. We agree with the Emerging Views that PQP28 should not include additional bespoke financial incentive mechanisms for expenditure or quality.[55] The first PQP should avoid unnecessary complexity and should allow the core regulatory framework to establish itself. The revenue cap, scrutiny of expenditure forecasts, independent verification, information disclosure, annual compliance reporting and future price-path resets will together provide incentives for efficiency and accountability.

100. It would be premature to introduce additional financial mechanisms before there is evidence that the core PQP design is insufficient to promote efficient expenditure, innovation, service quality and consumer outcomes.

Pass-through costs should be defined upfront wherever possible

101. We support pass-through treatment for government levies[56] and recommend that the Commission should also provide for pass-through treatment of:

    101.1. council rates as these are already treated as pass-through costs by electricity distribution businesses and Chorus;[57] and

    101.2. Fire and Emergency New Zealand (FENZ) levies which are treated as pass-through costs by Transpower.[58]

102. These costs are not controllable by us and should not be treated in the same way as operating expenditure.

Reopeners should include financeability as well as those already used for Part 4 and Part 6

103. We also support reopeners for catastrophic events, legislative or regulatory change, error events, and financeability pressures. The catastrophic event reopener should specifically cover severe weather and climate-related events, including flooding, drought, storms, slips, coastal inundation and other events that materially affect network performance, costs or delivery requirements. The criteria should be clear enough to provide certainty, but not so narrow that the mechanism cannot respond to the types of events that are most relevant to water and wastewater infrastructure.

104. However, reopeners should not be relied on as a substitute for building sufficient financial headroom into the price path. Even where a reopener is available, the process of preparing an application, testing evidence, consulting and obtaining a decision can take considerable time. Reopeners also have a significant lag between the triggering event and the recovery of revenue. Even where a reopener is approved, revenue is typically introduced over time to manage

[55] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at [XX].

[56] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 6.44.

[57] Commerce Commission, *Fibre Input Methodologies Determination 2020* (3 September 2025), at 3.1.2.

[58] Commerce Commission, *Transpower Input Methodologies Determination* (4 June 2026), at 3.1.3(1)(f).

customer price impacts. This means recovery may occur well after the relevant cost pressure or financeability issue has arisen, during which we must continue to fund essential services and committed investment. Regulatory settings which enable a cash buffer are therefore necessary to manage shocks in real time, with reopeners operating as a backstop for exceptional events rather than the primary mechanism for maintaining financial resilience.

105. The reopener process must be timely and workable. A reopener that takes too long to determine may not be effective where we face an immediate financing or delivery issue. We recommend that the Commission adopt a two-stage reopener framework for material, unforeseen events. Where an immediate shock has a significant impact on our ability to finance or deliver regulated services, the Commission should be able to make an interim adjustment to allowable revenue based on the best information reasonably available at the time. This would provide timely relief where waiting for a full evidential process would create unnecessary financeability or operational risks. The interim adjustment could then be subject to a subsequent confirmation process once sufficient information has become available to undertake a robust assessment. Any difference between the interim adjustment and the final amount would be corrected through an NPV-neutral wash-up at the next reset. This approach balances regulatory responsiveness with accuracy, ensuring that consumers are protected from over-recovery and that we are not exposed to prolonged under-recovery arising from events outside our reasonable control.

Balancing financial resilience with cash surpluses

106. An appropriate cash buffer is necessary to maintain financial resilience and respond to unforeseen events, including severe weather events and operational disruptions, since we cannot quickly raise equity like other regulated businesses. However, we are also open to mechanisms that limit the accumulation of excessive cash surpluses where these can be implemented in a simple and proportionate manner. This could be achieved through voluntarily pricing below the MAR, rules that limit cash surpluses,[59] or targeted mechanisms similar to Frontier Economics' customer contribution. The key consideration is that any mechanism should not be unduly complex or constrain our ability to manage risk and maintain efficient investment.

107. A mechanism similar to, but not necessarily the same as, Frontier Economics' suggested customer contribution[60] could help ensure that we have sufficient funding to deliver the prudent and efficient capital expenditure allowed by the Commission, while also maintaining a benchmark level of debt commensurate with the benchmark level of gearing adopted by the Commission when setting the WACC allowance. In this approach, customers effectively take the role of equity holders and supply the necessary funds for investment (and receive them back when capex requirements are decreasing). This is an NPV-neutral adjustment that ensures that the notional leverage of the RAB for the benchmark efficient firm modelled in the BBM stays at the benchmark level, consistent with the Commission's usual assumption.

Wash-ups

108. We support the Commission's proposal to include targeted wash-ups for revenue under- or over-recovery, CPI differences, and pass-through costs. These wash-ups are consistent with the proposed revenue-cap form of control and help ensure that we neither gain nor lose simply because actual revenue or inflation differs from forecast.

[59] Commerce Commission, *Price-Quality Path for Watercare Emerging Views Paper* (25 June 2026), at 3.32.

109. The final PQP28 determination should provide for the rollover of any relevant Charter wash-up balance into PQP28. The transition from the Charter to PQP28 should be financially neutral and should avoid stranding balances that were created under the interim regulatory framework. The Commission should specify how any under- or over-recovery under the Charter will be carried forward, recovered or returned in a transparent and NPV-neutral way.

VERIFICATION AND EXPENDITURE ASSESSMENT

Verification

110. Verification has been utilised by the Commission to provide scrutiny on the prudence and efficiency of expenditure forecasts in a number of sectors. We agree that, if verification is required, it should be targeted and proportionate. This means focusing on areas of expenditure that are material, higher risk or subject to greater uncertainty, rather than requiring comprehensive verification across all aspects of the proposal.[61]

111. Expenditure scrutiny should be targeted towards areas where meaningful improvements can still be made within the regulatory period. Many large capital investments are multi-year programmes that will be well advanced by the start of PQP28, limiting the scope for material changes without affecting delivery. The Commission should therefore carefully weigh the benefits of additional scrutiny against the risks to consumers if necessary investment is delayed, deferred or unable to proceed.

Expenditure assessment objectives

112. Thresholds for the scrutiny of expenditure should be set to recognise our current capability levels, and continued performance improvement journey under the Charter improvement plans in order to limit the risk that we are prevented from undertaking needed investment or activities by the regulatory settings.

113. We consider the Commission's Expenditure objective and Efficiency improvement objective are set at an appropriate level.

Charter improvement plan reporting

114. We continue to invest in implementation of the Charter improvement plans. We support ongoing reporting on our Charter improvement plans as currently required under the Charter in the current form for the duration of each plan. Any required changes to reporting requirements should be transparently justified as part of the PQ setting process.

There should be no bespoke financial incentives for PQP28

115. We agree that additional bespoke financial incentives and incentives on service quality are not necessary for PQP28. As we noted in our submission on the Commission's Approach paper, we consider the PQ framework itself provides inherent efficiency incentives. Expenditure allowances are fixed for the duration of the regulatory period, which incentivises us to manage costs efficiently. In addition, scrutiny and approval of the expenditure proposal establishes explicit efficiency expectations that we must meet over the regulatory period.

---

[61] Commerce Commission, *Price-Quality Path for Watercare - Approach Paper*, (26 November 2025), at 9.2 and 7.4 to 7.13.

116. 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.[62]

INFRASTRUCTURE GROWTH CHARGES

117. IGC revenues are subject to significant uncertainty due to the timing and scale of development activity. Material downside variance in IGC receipts could affect our cash flows and financeability during PQP28, particularly given the scale of Auckland's growth-related investment requirements. We recommend a targeted financeability reopener to manage circumstances where IGC receipts are materially lower than forecast and creating persistent or material financeability pressure.

118. We support the Emerging Views proposal not to impose minimum IGC increases during PQP28. Growth pricing reform is already underway, and the new pricing methodology should provide a more transparent and principled basis for IGCs than a minimum annual increase requirement. The Commission should continue to monitor the implementation of pricing reform and can consider additional reporting or controls if future evidence shows that they are needed.

THE COMMISSION'S DEMONSTRATION MODEL

119. While the Commission's demonstration model is necessarily illustrative, it provides a useful indication of the practical consequences of the proposed regulatory settings. The model shows financial capacity is too constrained when investment requirements are highest, with headroom emerging later in the regulatory period. This suggests the proposed settings do not strike the right balance between supporting investment when it is needed and providing financial resilience throughout the regulatory period. The key issue is therefore not the outcome of any particular model, but whether the overall package of regulatory settings provides sufficient financial capacity to support prudent and efficient investment as it falls due. Our proposed amendments are intended to better balance these objectives and create a more financeable outcome across the period.

120. The demonstration model outcomes are heavily dependent on a few critical assumptions, and long-term forecasts of our planned expenditures, cost of financing and IGC revenue. Care will need to be taken to ensure the assumptions and forecasts are robust, and stress tested before they are relied on to determine our initial regulatory settings.

---

62 Watercare Services Limited, *Submission to the Commerce Commission on Price-Quality Path for Watercare – Approach Paper,* (5 February 2026), at 2.38 to 2.42.



frontier economics

WACC and financeability for PQP regulation of Watercare

A report prepared for Watercare | 29 July 2026

Frontier Economics Pty Ltd is a member of the Frontier Economics network, and is headquartered in Australia with a subsidiary company, Frontier Economics Pte Ltd in Singapore. Our fellow network member, Frontier Economics Ltd, is headquartered in the United Kingdom. The companies are independently owned, and legal commitments entered into by any one company do not impose any obligations on other companies in the network. All views expressed in this document are the views of Frontier Economics Pty Ltd.

Disclaimer

None of Frontier Economics Pty Ltd (including the directors and employees) make any representation or warranty as to the accuracy or completeness of this report. Nor shall they have any liability (whether arising from negligence or otherwise) for any representations (express or implied) or information contained in, or for any omissions from, the report or any written or oral communications transmitted in the course of the project.

Contents

1 Introduction 1
1.1 Background 1
1.2 Our instructions 1
1.3 Key findings 1
2 Cost of capital 5
2.1 Objectives and guiding principles 5
2.2 Parameters common to all Part 4 businesses 6
2.3 Form of the Capital Asset Pricing Model 9
2.4 Comparator sample for estimating industry-specific parameters 14
2.5 Beta 25
2.6 Benchmark leverage 30
2.7 Benchmark credit rating 32
2.8 Term credit spread differential 33
2.9 WACC percentile 35
2.10 Indicative WACC estimates for PQP28 40
3 Financeability 42
3.1 Establishment of Watercare's opening RAB 42
3.2 Ongoing financing of capital expenditure 54
3.3 Maintaining ongoing financeability 58

Tables

Table 1: Commission's approach to estimating risk-free rate, MRP and cost of debt 7
Table 2: Commerce Commission's comparator sample 15
Table 3: Filters used by the Commission to select comparators in the 2023 IMs and in the *Emerging Views* paper 16
Table 4: Indicators for selecting Brazilian water companies 20
Table 5: Descriptions of Brazilian water companies 21
Table 6: Alternative comparator sample 24
Table 7: Mean asset beta estimates from Commission's proposed sample under different averaging scenarios 26
Table 8: Asset beta estimates for proposed comparators 29

Table 9: Leverage estimates for proposed comparators 31
Table 10: Credit rating of comparator firms 33
Table 11: TCSD allowance proposed by the Commission 33
Table 12: Benchmark tenor of debt adopted by Australian regulators 34
Table 13: Indicative estimates of WACC parameters and overall WACC 40
Table 14: Comparison of the PV of BBAR under the different options for setting the initial RAB value 54

Figures

Figure 1: Financeability – physical initial RAB 44
Figure 2: Financeability – financial initial RAB 44
Figure 3: Financeability – physical initial RAB with RAB indexation – Threshold ratios consistent with A- rating 49
Figure 4: Financeability – financial initial RAB without RAB indexation – Threshold ratios consistent with A- rating 50
Figure 5: Financeability – physical initial RAB without RAB indexation – Threshold ratios consistent with A- rating 52
Figure 6: Allowed real revenues ($FY2029) under a customer capex contribution approach 57
Figure 7: Leverage and FFO/net debt outcomes under a customer contribution approach 58

1 Introduction

1.1 Background

Watercare will transition to price-quality regulation under Part 4 of the *Commerce Act 1986* (**the Act**) in mid-2028. This will be the first price-quality path (**PQP**) determination by the Commerce Commission (**the Commission**) for any water entity in New Zealand. The Commission has indicated that it does not intend to develop Input Methodologies (**IMs**) prior to making the PQP28 decision. This is unlike the approach taken to any other industry currently regulated by the Commission.

The lack of IMs creates significant uncertainty for Watercare and other stakeholders about how the Commission will approach key elements of the PQP28 decision—including the method for determining Watercare's Weighted Average Cost of Capital (**WACC**)[1] allowance and treatment of financeability issues. Getting these settings right is critical to Watercare's ability to invest prudently and efficiently. As Watercare has previously submitted to the Commission, it expects to undertake a significant amount of investment in its network over the coming decade. These investment demands will place Watercare under significant financial pressure if it is not provided an appropriate WACC allowance, and if the regulatory framework does not provide Watercare with sufficient regulated cash flows to remain financeable.

Although the Commission does not intend to develop IMs prior to making its PQP28 decision, it published an *Emerging Views* paper on 25 June 2026, which set out for consultation its initial thinking on, amongst other things, its proposed approach to WACC and financeability for Watercare.

1.2 Our instructions

Watercare has engaged Frontier Economics to:

- review the approach to:
  - setting Watercare's cost of capital allowance for PQP28; and
  - financeability,

  proposed by the Commission in the *Emerging Views* paper; and
- advise on an appropriate method for both these issues, having particular regard to the unique constraints and circumstances imposed by legislation on Watercare.

1.3 Key findings

1.3.1 Cost of capital (section 2)

We make the following recommendations in relation to the approach the Commission should adopt when setting the cost of capital allowance for Watercare:

- The Commission should use the standard Capital Asset Pricing Model (**CAPM**) rather than the Simplified Brennan-Lally Capital Asset Pricing Model (**SBL-CAPM**) to estimate the cost of equity. The rationale for using the SBL-CAPM is that it adjusts the estimate of the total required return on equity for the benefit that eligible investors receive from dividend

[1] The Commission refers to 'WACC' and 'the cost of capital' interchangeably. This report adopts the same convention.

imputation under the New Zealand tax system. This presumes that investors in the regulated business do benefit from dividend imputation. However, Watercare is exempt from corporation tax, which means it has no means of generating imputation tax credits. Furthermore, Watercare is prohibited by law from paying dividends to its shareholder, so even if it could generate imputation tax credits, it has no way of distributing them to its shareholder. Consequently, Watercare's shareholder does not benefit from dividend imputation. Setting the cost of equity allowance as though they do would result in an underestimate of Watercare's cost of equity.

- The *Emerging Views* paper proposes a sample of 10 listed water network comparators (seven from the US and three from the UK) with which to estimate three key cost of capital parameters: the asset beta, benchmark leverage and the benchmark credit rating. However, the Commission proposes to rely on only the three UK firms to estimate the asset beta. This is too small a sample of comparators with which to derive statistically reliable estimates of beta.
- Using the approach that the Commission adopted in the 2023 IMs review, we have identified a sample of 14 listed water network comparator firms (seven from the US, three from the UK, three from Brazil and one from Hong Kong). All these firms comfortably pass the selection criteria used by the Commission to select comparators in its 2023 IMs. The Commission should adopt these 14 firms as its comparator set.
- Consistent with the Commission's established practice, the full set of comparator firms (i.e., all 14 companies) should be used to estimate the asset beta and the benchmark leverage. We also propose that all the firms in the sample with published credit ratings be used to derive an estimate of the benchmark credit rating. This would be entirely consistent with the approach adopted by the Commission in the 2023 IMs.
- The Commission should select a cost of capital point estimate equal to the 65th percentile of the estimated Weighted Average Cost of Capital (**WACC**) range. This would be consistent with the approach adopted by the Commission in relation to electricity networks. The Commission sets an overall cost of capital allowance above the midpoint (i.e., the 65th percentile) of the estimated WACC range for electricity networks because the Commission accepts that:
  - it cannot observe the true cost of capital of electricity networks – it can only estimate the cost of capital with uncertainty;
  - inadvertently setting the cost of capital allowance below the true cost of capital will disincentivise investment, while inadvertently setting the cost of capital allowance above true cost of capital would result in consumers paying more than the efficient cost of providing the service (all else remaining equal); and
  - electricity is such an essential service that the harm to consumers associated with underinvestment in electricity networks (i.e., the economic losses from lost consumption) likely outweighs the loss to consumers of paying more than the efficient cost of the service. That is, the consequences of underinvestment are asymmetric.
- All these things are true of water networks and the services delivered by water networks:
  - there is a significant need for new investment in Watercare's network to renew assets and lift service quality and reliability;
  - consumers would be materially worse off without that investment occurring;

- Watercare faces a real economic cost of funds, just as any other business does. This is recognised by the approach adopted by the Commission when estimating the cost of capital;
- the Commission itself has cited evidence that the services delivered by water networks are at least as essential to consumers as the services delivered by electricity networks; and
- This suggests that the Commission should adopt a WACC percentile when setting Watercare's cost of capital allowance that is at least as high as the WACC percentile adopted when setting the cost of capital allowance for electricity networks.

1.3.2 Financeability (section 3)

We make the following recommendations in relation to the approach the Commission should adopt to ensure that Watercare can remain financeable:

- The *Emerging Views* paper proposes to set Watercare's initial Regulatory Asset Base (**RAB**) value such that the forecast cash flows generated using that RAB value are sufficient to maintain a bare investment grade (i.e., a BBB-) credit rating. The Emerging Views considers that Watercare would be financeable if leverage is no more than 75%, and if FFO/net debt is in the range 9% to 13%.
- Targeting a bare investment grade credit rating would not provide Watercare with sufficient cash flow headroom to manage unexpected shocks and short-term cash flow shortfalls. We recommend, instead, that the following threshold ratios be used by the Commission to set Watercare's initial RAB value and to ensure that the benchmark efficient firm remains financeable on an ongoing basis:
  - Leverage (i.e., net debt/RAB): 55%; and
  - FFO/net debt: 15%.
- The *Emerging Views* paper proposes to adopt a benchmark credit rating of A- for the purposes of setting Watercare's cost of capital allowance. A leverage ratio of 55% and an FFO/net debt ratio of 15% are consistent with the minimum threshold values under Moody's rating methodology for a regulated water utility with an A- credit rating. Internal consistency requires that the threshold leverage and FFO/net debt ratios be commensurate with the benchmark credit rating adopted by the Commission.
- Our analysis using the supporting financial model published by the Commission suggests that the following two approaches would produce forecast cash flows that would allow a benchmark efficient firm in Watercare's position to support an A- credit at the benchmark level of leverage:
  - Set the initial RAB value in line with the value of Watercare's forecast physical RAB in 2028 and apply no RAB indexation for inflation for a period of time; or
  - Set the initial RAB value by adding an equity buffer to Watercare's forecast net debt in 2028 such that the leverage in that year is 55% (i.e., consistent with Moody's assessment of the leverage of an A- rate regulated water utility) and apply no indexation to this 'financial' initial RAB.

  Non-indexation of Watercare's RAB, under both approaches, for some period of time is essential to supporting Watercare's financeability. This is because Watercare has no means of raising new equity to manage financeability problems. Nor can Watercare increase its own

revenues to make up any cash flow shortfalls it may face, since its revenues will be capped by the Commission.

- When setting revenue allowances each regulatory period, the Commission assumes that the benchmark efficient firm will maintain constant leverage at the benchmark leverage ratio in each year of the regulatory period. To accomplish this, the Commission assumes that all new capex will be financed according to the benchmark capital structure. For instance, suppose the Commission adopts a benchmark leverage ratio of 33%. Then, the Commission assumes that every $100 of new capital expenditure will be financed using $33 of new debt and $67 of new equity. However, as the *Emerging Views* paper acknowledges, Watercare cannot raise any new equity.
- Hence, we propose that, to maintain the benchmark leverage assumption, an adjustment (i.e., an increment or a decrement) to Watercare's allowed revenues should be made to ensure it has just sufficient funds over the regulatory period to replace the equity capital that would otherwise be required to finance the forecast capex over that period. We refer to this revenue adjustment as a *customer capex contribution*, which can be positive or negative. The role of the customer capex contribution would be to provide Watercare with just sufficient regulated revenue over the period to undertake the prudent and efficient capex allowed by the Commission, while maintaining a constant level of leverage in each year.
- The *Emerging Views* paper recognises correctly that a benchmark efficient firm may face financeability problems in future, even if its initial RAB is set at a level that is intended to avoid such problems. Therefore, each time the Commission makes PQP decision for Watercare, it should conduct a formal financeability test that assesses whether the regulated cash flows over the forthcoming period would be sufficient to support the benchmark credit rating at the benchmark level of leverage.
- We propose that:
  - the Commission should publish a transparent financeability test that specifies a mechanistic rule for determining whether the test has been passed or failed;
  - the test should assess the financeability of the benchmark efficient firm rather than Watercare's actual financeability, since the failure of such a 'benchmark' test would exclude imprudent financing or inefficient operating decisions by the actual business as a source of the financeability problem;
  - the test should specify clear thresholds (rather than tolerance bands) for a failure or a pass so that the outcomes of the test are clear and predictable to Watercare and other stakeholders; and
  - the test should specify what binding action the Commission will take in the event the test is failed.

2 Cost of capital

2.1 Objectives and guiding principles

The *Emerging Views* paper confirms a number of important objectives and principles that will guide the Commission's method for setting the cost of capital allowance. Firstly, the Commission confirms that it will set allowed revenues for Watercare in a way that promotes the purpose of Part 4 of the Act (**the Part 4 purpose**):

> *Our goal is to set a PQP that promotes the long-term benefit of consumers by supporting efficient investment and improving cost efficiency and asset management practices, while maintaining service quality and limiting excessive profits. This would promote the s 52A purpose of Part 4 of the Act.*[2]

Whilst the Commission seeks to achieve the same objective when it regulates other businesses under Part 4 of the *Commerce Act*, it does not follow that the Commission should adopt the same method it uses to regulate other Part 4 businesses when setting revenue allowances for Watercare. This is because, as discussed below, Watercare faces several key legislative constraints that do not apply to other Part 4 businesses. The Commission should not ignore those constraints when setting Watercare's allowances because doing so may result in the Part 4 purpose not being met in Watercare's case.

The *Emerging Views* paper also explains how the Commission's approach to setting the cost of capital allowance *ought* to promote the Part 4 purpose:

> *The WACC reflects overall financing costs, combining the cost of equity, debt, and the firm's capital structure. The regulatory WACC promotes two limbs of the Part 4 purpose:*
>
> - *It allows for the recovery of efficient capital costs over time and provides appropriate incentives for ongoing investment in the regulated service.*
> - *It limits the ability to extract excessive returns, ensuring that consumer prices are not higher than necessary to finance an efficient firm.* [3]

The Commission is very clear in these statements that the cost of capital allowance should promote the Part 4 purpose by providing appropriate incentives for ongoing investment in the regulated service. However, as discussed in section 2.9 below, elsewhere in the *Emerging Views* paper the Commission contradicts the statements above by suggesting that the cost of capital allowance has a weak influence on Watercare's incentives to invest. As we explain below, we think

[2] *Emerging Views* paper, para. X9.

[3] *Emerging Views* paper, para. 5.2.

that such an assumption is incorrect; the cost of capital allowance does influence Watercare's ability and incentives to invest. In our view, the Commission should adhere to the statements above that setting the cost of capital allowance appropriately is important to ensuring the Watercare can invest efficiently.

Finally, the *Emerging Views* paper states that the Commission will adopt its usual approach of setting a cost of capital allowance for a benchmark efficient firm:

> *For PQP28, we propose to estimate the WACC using our benchmark efficient-firm approach, consistent with other Part 4 sectors, as well as the regulatory regime under Part 6 of the Telecommunications Act 2001 (Part 6). Our benchmark efficient-firm approach estimates the WACC as the return a hypothetical efficient firm with an efficient capital structure would require to compensate investors for investing in regulated assets.*[4]

We agree with the approach outlined by the Commission in the statement above. However, as explained below in section 3, the Commission departs from its established approach by:

- allowing the capital structure of the benchmark efficient firm's RAB to deviate from the benchmark leverage assumption used to set the WACC allowance; and
- allowing the capital structure of the benchmark efficient firm's RAB to vary over time.

For the reasons we explain below, we disagree with those departures from the Commission's standard approach. We recommend that the Commission maintain its usual approach of matching the capital structure of the benchmark efficient firm's RAB, and maintaining that capital structure at a constant level in each year of the regulatory period. At a minimum, the Commission should explain why it proposes these departures in the case of Watercare and how those departures would be consistent with the Part 4 purpose.

2.2 Parameters common to all Part 4 businesses

The Commission estimates several different WACC parameters, when setting an allowed return on capital. Some of these parameters are industry or firm-specific (e.g., the asset beta, benchmark leverage, the term credit spread differential (**TCSD**) allowance, the overall cost of equity and the WACC percentile).

Other parameters (e.g., the risk-free rate and the market risk premium (**MRP**)) are economy-wide parameters that apply to all firms and industries. Whilst the overall cost of debt allowance can vary between industries (e.g., due to the benchmark credit rating assumption) or between firms (e.g., due to the TCSD allowance), the Commission applies the same *method* for setting the overall cost of debt allowance to all the Part 4 businesses it regulates. Table 1 below summarises the Commission's current approach to these parameters common to all Part 4 businesses.

The methods used by the Commission to estimate the risk-free rate, MRP and cost of debt allowance have been contentious in the past. This is evident from the range of views on these parameters expressed by submitters to the Commission's recent cost of capital IMs review.[5] Notwithstanding this, Watercare has asked us to adopt, for the purposes of this report, the

[4] *Emerging Views* paper, para. 5.8.

[5] Commerce Commission, Common cost of capital input methodologies review (fibre and regulated suppliers under Part 4), Draft decision reasons paper, 10 March 2026.

Commission's existing methods for estimating the risk-free rate, MRP and cost of debt allowance. That is the approach we have adopted in section 2.10.

Table 1: Commission's approach to estimating risk-free rate, MRP and cost of debt

Parameter	Summary of Commission's estimation approach
Risk-free rate (same approach for cost of equity and cost of debt)	• Estimated using yields on New Zealand Government bonds. • Tenor of bonds matched to the length of regulatory period. • 3-month averaging window.
MRP	Average estimates produced by three approaches that use long-term historical returns data: • Ibbotson – long-term average of historical excess returns; • Siegel 1 – Ibbotson estimate adjusted for historical periods of 'surprise inflation'; and • Siegel 2 – long-term average of real historical market returns, plus current inflation forecast, less prevailing risk-free rate.
Cost of debt	• Add a 5-year historical average debt premium to an estimate of the prevailing risk-free rate at the start of the regulatory period. • Fix cost of debt allowance for duration of the period (i.e., no updating through the period). • Allow (as a separate revenue adjustment) a TCSD allowance to compensate businesses that issue debt with a tenor > 5 years.

Source: Frontier Economics.

Watercare has asked us to focus our advice on those parameters that are industry or firm-specific as these are the parameters for which the Commission may need to take a different approach to the one it follows for all other Part 4 businesses, to account properly for circumstances or constraints that are particular to Watercare. Hence, the remainder of section 2 of this report focusses on:

- the form of the asset pricing model that should be used to estimate Watercare's cost of equity (section 2.3);
- the method for selecting the comparators used to estimate the asset beta, benchmark leverage and benchmark credit rating (section 2.4);
- the method for estimating the asset beta (section 2.5);
- the method for estimating benchmark leverage and the approach to using that parameter to set the revenue allowance (section 2.6);

- the method for estimating the benchmark credit rating (section 2.7);
- the TCSD allowance (section 2.8); and
- the appropriate WACC percentile for Watercare (section 2.9).

There are three important considerations peculiar to Watercare arising from primary legislation that are germane to the method that should be used to estimate Watercare's cost of capital:

1. Watercare is exempt from paying corporation tax;
2. Watercare is prohibited from paying dividends to its shareholder; and
3. Watercare's shareholder are prohibited from providing Watercare with any form of financial support, including equity injections.

In our view, these three considerations require fundamental modifications to the Commission's standard cost of capital method, because application of that method would not (due to those factors) result in a cost of capital allowance that recover Watercare's efficient capital costs over time and provide appropriate incentives for it to undertake ongoing investment in the regulated service.

That is, our view is that the Part 4 purpose is best achieved by setting an allowed return on capital in line with the efficient cost of capital incurred by a benchmark business operating under the legislative constraints that apply to Watercare. The Part 4 purpose is not achieved by setting an allowed return for Watercare that is divorced from the commercial realities of the legislative constraints under which Watercare operates. These constraints have not been chosen by Watercare, they have been imposed by legislation.

However, the Commission does not propose to make any changes to its existing cost of capital method to accommodate Watercare's unique circumstances. Rather, the Commission has proposed to apply the same method it currently uses to regulate other Part 4 businesses when setting Watercare's cost of capital allowance for PQP28. The *Emerging Views* paper states that Watercare should use the Commission's standard cost of capital method in its PQP28 proposal, even though the existing cost of capital IM approach fails to address properly any of the three important considerations above:

> *Our emerging view for cost of capital is that Watercare should base its PQP28 proposal on the benchmark approach and parameters set out in this paper. This approach reflects the current IMs for WACC parameters that are common across sectors and does not incorporate any changes proposed in our draft decision on the common cost of capital input methodologies review.*[6]

The *Emerging Views* paper goes on to suggest that there would be insufficient time to develop and consult on any departures from its existing cost of capital method before PQP28:

[6] *Emerging Views* paper, para. 5.59.

Any significant changes from the review would likely require further development and consultation before they could be implemented. Given the absence of water-specific input methodologies, we would not propose to accelerate the development of any such changes for PQP28.[7]

In our view, such an approach would be wholly inadequate. The Commission is required to make determinations that promote the Part 4 purpose. As we explain below, unless the Commission makes a number of changes to its existing cost of capital method to account for Watercare's unique circumstances, Watercare's cost of capital allowance will be insufficient to recover its efficient cost of capital. This would undermine Watercare's incentives, and ability, to invest efficiently, which would not result in outcomes that would promote the Part 4 purpose. Such outcomes would ultimately be to the long-term detriment of consumers.

It is not credible or reasonable for the Commission to suggest, in 2026, that it has insufficient time before 2028 to review and consult on modifications to its existing cost of capital method that would, in our view, promote the Part 4 purpose.

In our view, it is self-evident that the Part 4 purpose is best achieved by setting an allowed return on capital in line with the efficient cost of capital incurred by a benchmark business operating under the legislative constraints that apply to Watercare. This is the task that the Commission is required to perform. Whether or not the Commission has time to properly perform that task is a separate issue. In the remainder of this section, we consider how the Part 4 purpose would be best met, having regard to the legislative constraints that apply to Watercare's provision of regulated services.

2.3 Form of the Capital Asset Pricing Model

2.3.1 Proposed approach in *Emerging Views* paper

The *Emerging Views* paper proposes that the Simplified Brennan-Lally Capital Asset Pricing Model (**SBL-CAPM**) should be used to estimate Watercare's cost of equity.

The SBL-CAPM has the form:

$$E[r_e]_{SBL} = r_f(1-T) + \beta_e\big(E[r_m] - r_f(1-T)\big),$$

where:

- r_f is the risk-free rate, per the standard Capital Asset Pricing Model (**CAPM**);
- β_e is the equity beta, per the standard CAPM;
- $E[r_m]$ is the expected return on the market, per the standard CAPM; and
- T is the maximum prescribed investor tax rate under the Portfolio Investment Entities (**PIE**) regime for investor tax.

Note that the SBL-CAPM formula collapses to the standard CAPM formula when $T = 0$. That is, the only difference between the SBL-CAPM and the standard CAPM is that the former applies an adjustment whereby the risk-free rate is multiplied by $1 - T$.[8]

[7] *Emerging Views* paper, para. 5.60.

[8] The Commission refers to the term $E[r_m] - r_f(1-T)$ as the Tax-adjusted Market Risk Premium (**TAMRP**).

This adjustment is designed to recognise that, under New Zealand's PIE regime, the investor tax rate is capped because capital gains on investments in shares are not taxed, and eligible investors receive imputation credits through dividends to avoid double-taxation via corporate and personal income tax. As the *Emerging Views* paper explains:

> *This SBL-CAPM approach reflects investor-level tax settings in New Zealand, including the use of imputation credits and the absence of a comprehensive capital gains tax.*[9]

2.3.2 Response to *Emerging Views* paper

The Commission's proposal to use the SBL-CAPM to estimate Watercare's cost of equity is a key example of how the Commission has failed to properly account for important factors that apply to Watercare, but which do not apply to other businesses that are price-quality regulated under Part 4 of the Act.

The standard CAPM provides an estimate of the minimum return required by equity investors in a regulated supplier. New Zealand investors that are eligible to receive and use imputation credits derive some real economic value from those credits in the form of lower income tax obligations. The SBL-CAPM provides an estimate of the required return on equity net of that economic benefit.

The total return required by equity investors in a regulated business in New Zealand (estimated using the standard CAPM) is the sum of the economic benefit that those investors receive from imputation tax credits (i.e., $E[r_e]_{im}$) and the estimated required return on equity net of that economic benefit (i.e., $E[r_e]_{SBL}$):

$$E[r_e] = E[r_e]_{im} + E[r_e]_{SBL}.$$

When the Commission applies the SBL-CAPM to set the cost of equity allowance for a regulated business, it is effectively deducting from its estimate of the total required return on equity an amount equivalent to its estimate of the economic benefit that investors receive from imputation tax credits:

$$E[r_e]_{SBL} = E[r_e] - E[r_e]_{im}.$$

That is, the Commission's application of the SBL-CAPM recognises that eligible investors in a regulated supplier in New Zealand receive some of their total required return on equity from the cost of equity allowance under the PQP regime and the remainder of their total required return from the imputation tax system.

[9] *Emerging Views* paper, para. 5.22.

Australia, like New Zealand, has an imputation tax system. Regulators in Australia, like the Commission, make an adjustment to suppliers' allowed revenues for precisely the same reason explained above.[10] For example, the Australian Energy Regulator (**AER**) has stated the following:

> *Under the Australian imputation tax system, investors receive an imputation credit for tax paid at the company level. For eligible shareholders, this credit offsets their Australian income tax liabilities. If the value of imputation credits exceeds an investor's tax liability, that investor can receive a cash refund for the balance. The credits are therefore a benefit to investors in addition to any cash dividend or capital gains from owning shares. The value of imputation credits has a range of possible values between zero and one.*
>
> *The value of imputation credits is important in regulation because it affects the estimation of building block revenue allowances. The measurement and estimation of the building block revenue allowances, including the rate of return, depends on whether cash flows are pre-tax or post-tax. We use a post-tax framework with a rate of return that is after company tax but before personal tax. Under a pre-tax WACC framework gamma[11] is a WACC parameter.* ***Tax credits provide value to investors by offsetting income tax liabilities. Considering this value, eligible investors would accept an investment with a lower rate of return than if there were no imputation tax credits.*** *In contrast, under a post-tax WACC framework, gamma is not a WACC parameter. Instead, it is a direct input into the calculation of tax liability for the company, via the corporate tax component of the building block model. This approach is consistent with standard Australian regulatory practice and is the approach prescribed in the rules.[12] [Emphasis added]*

Application of the SBL-CAPM may be appropriate for other suppliers regulated by the Commission under Part 4 of the Act. However, it is unsuitable for Watercare for two reasons:

- Watercare, being a qualifying council-controlled organisation, is exempt by law from paying corporation tax, and therefore does not create any dividend imputation credits;[13] and
- Watercare is prohibited by law from paying any dividend or distributing any surplus in any way, directly or indirectly, to its owner, so would be unable to distribute any credits to its equity holders even if it had such credits available.[14]

Neither of these circumstances apply to any of the other suppliers that are subject to PQP regulation under Part 4 of the Act.

[10] In practice, regulators in Australia make this adjustment via the tax building block rather than the cost of equity allowance. While the mechanics of the adjustment in Australia and New Zealand differ, the underlying rationale for the adjustment is the same.

[11] In the Australian regulatory context, the parameter gamma is an estimate of the economic value derived by investors from imputation tax credits.

[12] Australian Energy Regulator, Draft rate of return guideline, Explanatory Statement, August 2013, p. 116.

[13] Section CW 39 Local authorities, *Income Tax Act 2007*.

[14] Section 57, *Local Government (Auckland Council) Act 2009*.

The Commission recognises in the *Emerging Views* paper that Watercare is exempt from paying corporation tax and is prohibited from paying dividends, but argues that these factors do not alter Watercare's cost of capital:

> *The cost of equity reflects the post-tax return investors would require to invest in assets with similar systematic risks. Although Watercare is corporate tax-exempt and pays no dividends, this does not change the underlying risk of its assets or the opportunity cost of capital. Therefore, the return on equity will be estimated on a post-tax basis, reflecting the return required to compensate investors for the systematic risks of Watercare's assets, consistent with our benchmark approach.*[15]

We agree that Watercare's tax exempt status and its restriction on paying dividends do not alter its cost of capital. However, these factors do alter its owner's ability to receive and benefit from imputation credits:

- Imputation tax credits are generated when a firm or entity pays corporation tax. Since Watercare is exempt from paying corporation tax, it has no way of generating imputation credits; and
- Imputation tax credits are distributed when a firm pays dividends to its shareholders. Since Watercare is prohibited by law from paying dividends, it has no way of distributing imputation credits to its owner, even if it could generate those credits.

This means that Watercare's owner, Auckland Council, has no way of receiving and benefiting from dividend imputation—unlike the owners of all other businesses subject to PQP regulation under Part 4 of the Act. Since Watercare's investors receive no economic benefit from the dividend imputation regime, Watercare's cost of equity allowance should be set equal to the cost of equity estimate derived from the standard CAPM.

The SBL-CAPM does not estimate the return required by equity holders from their investment in a water utility – it estimates the portion of that required return that comes from the regulatory allowance rather than from imputation credits. The standard CAPM estimates the total required return on equity, the SBL-CAPM essentially deducts from this the return available from imputation credits, leaving the return to be provided from the regulatory allowance.

Thus, even if Watercare has the same systematic risk as a comparable business that is not subject to the legislative constraints, the standard CAPM should be used for Watercare. No deduction for imputation credits should be made for Watercare because its equity investors receive no benefit from imputation credits. Put another way, setting the regulatory allowance for Watercare under the assumption that its equity investors benefit from imputation credits, when they in fact do not, results in systematic under-compensation.

The SBL-CAPM will produce a lower estimate of the cost of equity than the standard CAPM when $T > 1$ and $\beta_e < 1$, all else remaining equal. The *Emerging Views* paper proposes to adopt $T = 28\%$. Furthermore, both our estimate of Watercare's equity beta (see section 2.10) and the Commission's estimate is less than 1. Hence, use of the SBL-CAPM will result in a cost of equity allowance that is below Watercare's true cost of equity capital. It would therefore not be appropriate to apply the SBL-CAPM to Watercare.

[15] *Emerging Views* paper, para. 5.17.

The *Emerging Views* paper asserts the following:

> *We propose to estimate the cost of equity using the SBL-CAPM consistent with our approach in other regulated sectors. This model provides a suitable framework for estimating the opportunity cost of equity for a benchmark efficient firm.*[16]

The SBL-CAPM is only a suitable framework for estimating the opportunity cost of equity for a benchmark efficient firm whose owners benefit from dividend imputation. In the case of a benchmark efficient firm in Watercare's circumstances, whose owners cannot benefit from imputation credits, the SBL-CAPM will produce an underestimate of the of opportunity cost of equity. The size of the under-compensation being:

$$Under\text{-}compensation = E[r_e] - E[r_e]_{SBL}.$$

As noted correctly by the Commission, "the cost of equity reflects the post-tax return investors would require to invest in assets with similar systematic risks."[17] The implication of this statement is that investors in two suppliers with identical systematic risks have the same total required return. However, suppose the owners of one these suppliers benefited from imputation credits, but the other did not, and the Commission set the cost of equity allowance for both assets using the SBL-CAPM. Then, the investors that received no benefit from imputation tax credits would receive a lower total return than they require, and a lower total return than the investors in the other supplier, because those investors would derive some economic benefit from dividend imputation.

By way of an illustrative example, consider two suppliers A and B of identical systematic risk, both with an equity beta of 0.6. Suppose further that:

- the risk-free rate is 5%;
- the expected return on the market is 11%;
- the average investor tax rate is 28%; and
- the equity investors in supplier A benefit from imputation credits, but the equity investors in supplier B do not.

The investors in both suppliers should have the same total required return on equity, which may be estimated using the standard CAPM:

$$9.44\% = 5\% + 0.6 \times (11\% - 5\%).$$

Suppose also that the Commission sets the cost of equity allowance for both suppliers using the SBL-CAPM. Then both suppliers will receive the following allowance via the regulatory regime:

$$8.04\% = 5\% \times (1 - 28\%) + 0.6 \times (11\% - 5\% \times (1 - 28\%)).$$

If the SBL-CAPM correctly values the benefit of imputation tax credits, then investors in supplier A will receive a total return of 9.44% (matching the total required return): 8.04% through allowed revenues and a further benefit of 1.40% from imputation credits. However, investors in supplier B

[16] *Emerging Views* paper, para. 5.20.

[17] *Emerging Views* paper, para. 5.17.

will only receive 8.04% through allowed returns, since they receive no economic benefit from imputation credits. Investors in supplier B will therefore be under-compensated by 1.40%. The only way to address this under-compensation would be to set supplier B's cost of equity allowance using the standard CAPM, rather than the SBL-CAPM, recognising that investors in supplier B receive no economic benefit from dividend imputation.

The *Emerging Views* paper states that the application of the SBL-CAPM, and the proposed parameter values that would be used to estimate it (i.e., the TAMRP and the average investor tax rate) "reflect established cross-sector assumptions and promote consistency across regulatory regimes."[18] We agree that consistent regulatory outcomes across industries and regulatory regimes administered by the Commission is important. However, the Commission's proposal to apply the SBL-CAPM to set the cost of equity allowance for a supplier whose investors cannot benefit from imputation credits results in a material *inconsistency* between industries and regulatory regimes. For all other industries, the Commission will set a cost of equity allowance that (together with the benefits derived from dividend imputation) will deliver an expected return that matches investors' required return on equity. This would promote the Part 4 purpose.

However, in Watercare's case, the Commission's proposed approach will deliver an expected return that is *below* Watercare's cost of capital. This would *not* promote the Part 4 purpose.

By way of analogy, it would be consistent to set the speed limit at a level that is safe in the relevant circumstances of each road. The Commission is essentially proposing to set the same limit for a highway and a school zone on the basis of 'consistency.'

To avoid this outcome, we propose that the Commission use the standard CAPM, rather than the SBL-CAPM, to set Watercare's cost of equity allowance.

2.4 Comparator sample for estimating industry-specific parameters

2.4.1 Proposed approach in *Emerging Views* paper

The Commission's conventional approach is to compile a sample of listed comparators drawn from the same industry as the one being regulated by the Commission to estimate three industry-specific parameters:

- the asset beta;
- benchmark leverage; and
- benchmark credit rating.[19]

The Commission constructed its proposed comparator sample by first finding all firms listed as "water utilities" under the Bloomberg Industrial Classification Standard. This identified a long list of 412 firms.

[18] *Emerging Views* paper, para. 5.24.

[19] Typically, only a subset of the comparators identified by the Commission will have a public credit rating. Hence, the Commission's established method is to rely on those comparators that are rated to derive its estimate of the benchmark credit rating. The key point is that the Commission does not consider firms outside its comparator set when determining the benchmark credit rating.

The Commission then applied several criteria to narrow this down to 20 firms. The Commission only included firms:

- with a market capitalisation of at least $100 million USD to exclude stocks that are likely to be illiquid. It is important to exclude illiquid stocks from the comparator set because, as is well recognised in the finance literature, the beta estimates of illiquid stocks tend to be biased;
- whose revenue from "water utilities" activities account for at least 70% of total revenue (as calculated by Bloomberg) to exclude firms engaged substantially in activities that have a different risk profile to the regulated activities; and
- operating in countries with equity markets classified by FTSE as "developed" to exclude firms that operate in countries with a materially different risk profile and trading environment to New Zealand's.

The Commission then considered the suitability of each firm by examining the firm descriptions and annual reports and dropped one comparator (founded in April 2025) due to insufficient data. This resulted in the Commission's final comparator sample of 10 firms summarised in Table 2.

Table 2: Commerce Commission's comparator sample

Company name	Jurisdiction
American States Water Company	US
American Water Works Company Incorporated	US
Artesian Resources Corporation	US
California Water Service Group	US
H2O America	US
Middlesex Water Company	US
York Water Company	US
Pennon Group Public Limited Company	UK
Severn Trent Public Limited Company	UK
United Utilities Group Public Limited Company	UK

Source: Commerce Commission.

2.4.2 Response to *Emerging Views* paper

In respect of the proposed process for comparator selection, beta estimation and estimation of benchmark leverage, the *Emerging Views* paper states that:

> *For PQP28, we have applied our established methodology without modification for most of this process, while updating assumptions only where sector-specific inputs and judgement are required.*[20]

However, as we discuss below, the *Emerging Views* paper departs from the methods adopted by the Commission for selecting comparators in the 2023 IMs in a number of ways with no clear explanation or justification. Table 2 compares the key filters used by the Commission in the 2023 IMs and in the *Emerging Views* paper to select comparator firms.

Table 3: Filters used by the Commission to select comparators in the 2023 IMs and in the *Emerging Views* paper

Filter	2023 IMs – Energy	2023 IMs – Airports	*Emerging Views* paper
Liquidity	• Bid-ask spreads. • Free float %.	• Bid-ask spreads. • Free float %.	Market capitalisation ≥ $100 million USD.
Country of operations	Firms operating in 'developed' economies only.	Firms operating in 'developed' economies. Also included firms operating 'advanced emerging' economies (provided firms have relatively low asset beta variability) to increase sample size.	Firms operating in 'developed' economies only.
Leverage	No explicit requirement for positive leverage.	Must have positive leverage.	No explicit requirement for positive leverage.
Business activities	Exclude networks with a low % of regulated revenues. No minimum threshold for % of regulated revenues specified explicitly.	Exclude firms with a low % of aeronautical revenues. No minimum threshold for % of aeronautical revenues specified explicitly.	Revenue from water utilities ≥ 70%.

Source: Frontier Economics

[20] *Emerging Views* paper, para. D.7.

As far as we can tell these departures are not due to sector-specific circumstances. On the face of it, it seems that the Commission has adopted an approach that is inconsistent with its established method in some key respects. We discuss these inconsistencies below.

Liquidity filters

As noted above, the *Emerging Views paper* screens for stock illiquidity by excluding any firms with a market capitalisation less than $100 million USD. The Commission adopted this approach in the 2020 Fibre IMs. While some regulators do use market capitalisation as a liquidity filter (on the grounds that illiquid firms tend to be small), the 2023 IMs used bid-ask spreads and free float percentage (i.e., the percentage of shares traded), rather than market capitalisation, to screen for stock illiquidity.

The *Emerging Views* paper does not explain why market capitalisation, rather than bid-ask spreads and free float percentage, is used to select water sector comparators.

While these three indicators would generally tend to exclude the same firms, there can be exceptions. For example, the *Emerging Views* paper proposes the inclusion of Artesian Resources Corporation. However, this firm has a relatively high bid-ask spread of 1.15%. We note that in the 2023 IMs:

- the Commission rejected Chesapeake Utilities Corp from its energy comparator sample, partly on the grounds that it had a bid-ask spread as high as 0.5%;[21] and
- none of the airport comparators selected by the Commission had a bid-ask spread greater than 0.63%.[22]

Artesian Resources Corporation is unlikely to have been selected as a valid comparator, had the *Emerging Views* paper applied a bid-ask spread filter as the Commission did in the 2023 IMs. We note that this company has a market capitalisation of just $320 million. This relatively small size may explain its illiquidity. On that basis, and for consistency with the approach taken in the 2023 IMs, we propose that Artesian Resources Corporation be excluded from the comparator sample.

Country filters

As noted above, the *Emerging Views* paper proposes to include in the comparator sample only those firms that operate in "developed" economies. This is consistent with the approach taken by the Commission to energy network comparators in the 2023 IMs. However, that approach yielded a large sample of 51 energy network comparators. In the present case, restricting the sample to just comparators operating in developed economies yielded a sample of just 10 water network comparators.

In our view, there is a trade-off between the size of the comparator sample and the comparability of firms within the sample. Restricting the sample to only the most comparable of firms (e.g., in terms of their operating activities or the extent of development of the economies in which they operate) reduces the scope for bias in the estimates of beta, leverage and credit rating. However, the beta estimates of individual firms tend to be highly imprecise. This means that the smaller the comparators sample, the greater the scope for statistical/sampling error. Increasing the size of the sample tends to reduce the statistical uncertainty of the overall beta estimate (since some of the estimation error associated with individual firms will likely 'average out') but may permit the inclusion of less comparable firms in the sample.

---

[21] Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, para. 4.235.4.

[22] Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, Attachment D.

The Commission is alive to this trade-off. For example, when explaining how it had exercised judgment to select airport comparators in the 2023 IMs, the Commission stated that:

> *We were balancing the risk of having a small sample with the risk of including firms that are poor comparators…*[23]

During the 2023 IMs review, some submitters proposed that firms operating in the US should be excluded from the energy comparator sample on the grounds that they are subject to a different form of regulation than the energy networks regulated by the Commission under Part 4 of the Act. The Commission stated that:

> *We do not consider it practical to restrict the sample to only those companies that are regulated in a similar way as in New Zealand because this would exclude many of the US companies, and in our view the most important characteristic of an energy comparator is whether it is an energy utility rather than an energy utility regulated in a comparable manner.*[24]

Had the Commission adopted the proposal to exclude firms from the US, it would have been left with an energy network comparator sample of just six firms (i.e., three from the UK and three from Australia). This would have been too small a sample from which to derive statically reliable estimates. The Commission sensibly opted for the much larger sample of 51 comparators, even though that meant slightly less comparability within the comparator set.

On the question of the 'country filter', it is instructive to consider the approach taken by the Commission in respect of the airport comparators in the 2023 IMs. There, the Commission decided to permit firms operating in economies classified by FTSE as "advanced emerging" (subject to further checking of company operations). The Commission took that decision because restricting the sample to firms operating in "developed" economies only would have produced too small a comparator set to reliably estimate the asset beta, benchmark leverage and benchmark credit rating. The Commission's final airports comparator sample included one company from an advanced emerging nation: Airports of Thailand.

We think a similar approach in this instance would be appropriate, given the relatively small number of listed water companies globally. Larger comparator sample comparator samples will tend to increase the statistical reliability of the overall point estimate. Larger samples will also tend to produce more stable estimates over time, since averaging estimates over a larger sample will tend to produce overall point estimates that are less influenced by outlier estimates driven by random statistical variation.

We note that the Commission has excluded Guandong Investment Ltd (a company listed in Hong Kong) partly on the grounds that it has "activity in Mainland China."[25] (The Commission's other

[23] Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, para. 4.74.

[24] Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Draft decision, 14 June 2023, para. 4.88.

[25] *Emerging Views* paper, Table D.2.

reason for excluding this company is that it has significant exposure to other infrastructure services—a point we deal with in the next sub-section.) However, we note that in the 2023 IMs, the Commission included two airport companies listed in Hong Kong — Hainan Meilan International Airport and Beijing Capital International Airport — both with 100% of their operations in Mainland China. On that basis, it would be inconsistent for the Commission to now exclude from its water comparator sample Guandong Investment Ltd on the grounds that some of its operations are based in Mainland China.

We have also identified three Brazilian water companies that we consider should be included in the comparator sample on the grounds that all three:

- have a market capitalisation in excess of $100 million USD;
- have bid-ask spreads lower than 0.6% and free float percentages of at least 30%;[26, 27]
- derive at least 70% of their activities from water utilities activities (according to Bloomberg data); and
- operate in Brazil, which is classified by FTSE as an advanced emerging economy.

Table 4 below demonstrates that the three Brazilian companies satisfy the requirements for inclusion within the sample above. Table 5 presents the descriptions for each of the three Brazilian firms to show that they are each involved in relevant activities for inclusion in the water comparator sample.

In our view, excluding these three companies from the sample simply because Brazil's economy is dissimilar to New Zealand's is not a sound approach. We note that in the 2023 IM review the Commission included in its airports sample:

- one company based in Thailand (Airports of Thailand); and
- two companies listed in Hong Kong but which operate exclusively in China (Hainan Meilan International Airport and Beijing Capital International Airport).

Thailand and China are very dissimilar economies to New Zealand, yet the Commission chose to include companies that operate in those countries in its airports sample. If the Commission was willing to accept these three firms in its airports comparator sample, we see no good reason why it should exclude the three Brazilian firms identified above, since they easily satisfy the criteria for inclusion adopted by the Commission in the 2023 IMs.

[26] We note that the Commission included Hainan Meilan International Airport in its airport comparator sample even though it had a bid-ask spread as high as 0.63%. Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, Attachment D.

[27] We note that the Commission included Airports of Thailand in its airport comparator sample even though it had a free float percentage of just 28.35%. Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, Attachment D.

Table 4: Indicators for selecting Brazilian water companies

Ticker	Name	Market capitalisation	Bid-ask spread	Free float %	% revenue from water utilities
CSMG3 BZ Equity	Cia Saneamento de Minas Gerais	$4,467m USD	0.09%	50%	89%
SAPR4 BZ Equity	Cia Saneamento do Parana Senepar	$1,401m USD	0.26%	100%	100%
SBSP3 BZ Equity	Cia Saneamento Basico de Estado Sao Paolo	$20,213m USD	0.06%	56%	100%

Source: Frontier Economics analysis of Bloomberg data.

Table 5: Descriptions of Brazilian water companies

Name	Company description
Cia Saneamento de Minas Gerais	Companhia de Saneamento Basico do Estado de Sao Paulo - SABESP is a water and sewage service provider. The Company provides water and sewage services to a range of residential, commercial, industrial and governmental customers in over 375 municipalities in the state of Sao Paulo, including the city of Sao Paulo. The Company's segments include Water and Sewage. The Company's activities comprise water supply, sanitary sewage services, urban rainwater management and drainage services, urban cleaning services, solid waste management services and related activities, including the planning, operation, maintenance and commercialization of energy, and the commercialization of services, products, benefits and rights that directly or indirectly arise from its assets, operations and activities.
Cia Saneamento do Parana Senepar	Companhia de Saneamento de Minas Gerais COPASA MG, formerly Companhia Mineira de Agua e Esgoto - Comag, is a Brazil-based company engaged in the water supply and sanitation services. The Company's activities in the area of basic sanitation encompass the set of services, infrastructure, and operational facilities for potable water supply, sewage disposal and urban cleaning and solid waste management. The Water Supply segment covers all activities and infrastructure required for delivering potable water to consumers, from intake to building connections and metering. The Sewage segment focuses on collecting, transporting, and treating wastewater before its final environmental disposal. Additionally, the Company manages urban cleaning and waste services, including the collection, transportation, treatment, and disposal of household waste and debris from street sweeping and public space maintenance.
Cia Saneamento Basico de Estado Sao Paolo	Companhia de Saneamento do Parana Sanepar, formerly Companhia de Agua e Esgotos do Parana - Agepar, is a Brazil-based company active in the provision of basic sanitation services. The Company is primarily engaged in the water distribution, as well as in the collection and treatment of sewage. The Company is also involved in the studies, projects and expansion of water distribution networks, collection networks and sewage treatment infrastructure. Additionally, Companhia de Saneamento do Parana Sanepar provides collecting and processing of solid waste. In addition, it provides consulting services and technical assistance. The Company collaborates with agencies, governmental and municipal state entities. Companhia de Saneamento do Parana Sanepar operates in 346 municipalities.

Source: LSEG.

We also note that in the 2023 IMs the Commission considered the inclusion of one airport firm from Mexico and another airport firm from Malaysia (Mexico and Malaysia being advanced emerging economies). These two companies were only excluded by the Commission on the grounds that both firms had relatively high beta variability (i.e., 0.26 and 0.27, respectively). Our investigations suggest that the three Brazilian companies have very low beta variability:[28]

- Cia Saneamento de Minas Gerais – maximum beta variability of 0.149;
- Cia Saneamento do Parana Senepar – maximum beta variability of 0.060; and
- Cia Saneamento Basico de Estado Sao Paolo – maximum beta variability of 0.070.

Based on the analysis above, we propose that these three Brazilian companies should be included within the Commission's comparator sample.

Business activities

The Commission has excluded from the comparator sample two firms on the grounds that they have significant exposure to activities other than water utilities services, which we consider should be included within the sample.

The Commission excluded Guangdong Investment Ltd partly on the grounds that it has "significant exposure to other infrastructure services", notwithstanding that, according to the Commission's own analysis, 73% of this company's revenues derive from water utilities activities. According to Guangdong Investment Ltd's 2025 annual report, the company has six business segments:

- Water resources;
- Property investment;
- Department store operation;
- Electric power generation;
- Hotel operation and management; and
- Road and bridge management.

The annual report makes clear that in 2025 75.11% of the company's revenues derived from the Water resources segment (up from 73.01% in 2024).[29] The company's website describes the activities of the water resources segment as follows:

> *The water resources business mainly covers natural water supply, tap water supply, sewage treatment and waterworks construction. The natural water supply business is conducted under the Dongshen Water Supply Project which provides natural water to Hong Kong, Shenzhen and Dongguan. The tap water supply business mainly consists of the Wuzhou Water Supply Project, the Meizhou Water Supply Project and the Danzhou Water Supply Project. The sewage treatment*

[28] To calculate the asset beta variability we followed the approach adopted by the Commission in the 2023 IMs. We calculate the variability by finding for the last two periods the difference between weekly and 4 weekly asset beta estimates, and taking the highest difference. For example, for Cia Saneamento de Minas Gerais in 2021-2026 the weekly Ab was 0.563 and the four weekly was 0.712, a difference of 0.149. This was larger than the 2016-2021 difference of 0.021 so 0.149 is taken as the asset beta variability.

[29] Guangdong Investment Ltd, Annual report 2025, p. 8.

business includes the Meizhou Sewage Project, the Wuzhou Sewage Project and the Jinsheng Sewage Project.[30]

In other words, 75% of the company's revenues derive from natural water supply, tap water supply, sewage treatment and waterworks construction. These are all activities that Watercare is engaged in. Whilst Guandong Investment Ltd is exposed to other infrastructure activities, those activities represent less than 25% of the company's revenues. For these reasons, we consider Guandong Investment Ltd is a relevant comparator and therefore should be included within the Commission's water comparator sample.

The Commission excluded Essential Utilities Inc from the comparator sample on the grounds that only 54.7% of its revenues derive from water utilities activities, with the remaining 45.3% deriving from natural gas distribution services. The Commission argues that "natural gas services is not overly comparable to Watercare, which provides entirely water utility services."[31]

We agree that Essential Utilities is not an ideal comparator for Watercare. However, natural gas network businesses share many systematic risk characteristics with water network businesses. For example, both types of businesses:

- tend to be natural monopolies offering services with a relatively low price elasticity of demand;
- tend to have high operating leverage; and
- are capital intensive with long-lived assets, so tend to be influenced by interest rates, inflation expectations and capital market conditions than by short-term changes in operating revenues.

Given the relatively small number of firms within the comparator sample, and given the common systematic risk drivers between gas and water networks, we propose that the Commission relax its selection criteria in this case to include Essential Utilities Inc within the comparator sample.

Alternative comparator sample

In summary, we propose that the Commission:

- exclude from the comparator sample Artesian Resources Corporation on the grounds that it has a relatively high bid-ask spread (1.15%) and is therefore likely to be an illiquid stock;
- include Guandong Investment Ltd because more than 75% of its revenues are derived from activities similar to Watercare's and because in the 2023 IM review the Commission included within its airport sample two Hong Kong listed firms, notwithstanding 100% of their operations were in Mainland China; and
- include three Brazilian water companies (Cia Saneamento de Minas Gerais, Cia Saneamento do Parana Senepar, Cia Saneamento Basico de Estado Sao Paolo) since the Commission has previously loosened its country filter to include firms operating in "advanced emerging" economies when the comparator sample is relatively small, and because these three companies comfortably satisfy all the Commission's other criteria for inclusion in the comparator sample; and

30 https://www.gdi.com.hk/en_US/about/company-profile/index.html (accessed 2 July 2026).

31 *Emerging Views* paper, footnote 128, p. 104.

- include Essential Utilities Inc, notwithstanding over 45% of its revenues derive from gas distribution services, because the systematic risks of water networks businesses and gas distribution businesses are sufficiently similar for Essential Utilities Inc to be a useful comparator.

As Table 6 shows, implementation of these changes would result in a sample of 14 comparators.

Table 6: Alternative comparator sample

Company name	Jurisdiction
American States Water Company	US
American Water Works Company Incorporated	US
California Water Service Group	US
H2O America	US
Middlesex Water Company	US
York Water Company	US
Essential Utilities Inc	US
Pennon Group Public Limited Company	UK
Severn Trent Public Limited Company	UK
United Utilities Group Public Limited Company	UK
Guangdong Investment Ltd	Hong Kong listed
Cia Saneamento de Minas Gerais	Brazil
Cia Saneamento do Parana Senepar	Brazil
Cia Saneamento Basico de Estado Sao Paolo	Brazil

Source: Frontier Economics.

All these comparators:

- are listed in developed or advanced emerging countries (as classified by FTSE);
- have a maximum asset beta variation of 0.5;
- have a bid-ask spread less than 0.60% over the five years to March 2026;
- have a free-float percentage of at least 30%;
- have market capitalisation of at least $100 million USD;
- have positive leverage;[32] and

[32] Guangdong Investment Ltd has negative leverage over the 2011-16 and 2016-21 sample periods. Therefore, only the 2021-2026 estimates of Guangdong Investments are used in our analysis.

- derive 70% or more of their total revenues from water utilities (with the one exception of Essential Utilities Inc).

2.5 Beta

2.5.1 Proposed approach in *Emerging Views* paper

As noted in section 2.4.1, the *Emerging Views* paper identifies a comparator sample of 10 listed water companies, of which seven operate in the US and three operate in the UK. The Commission then estimates asset betas for each comparator:

- using weekly and four-weekly returns data; and
- three five-year historical periods: 2011 to 2016, 2016 to 2021 and 2021 to 2026.

This is consistent with the approach adopted in the 2023 IMs.

In the 2023 IMs the Commission used the beta estimates from the two most recent five-year historical periods to determine its overall point estimate of beta. Whilst the *Emerging Views* paper is not explicit on this point, it appears that the Commission proposes to derive an overall point estimate by averaging estimates over all three historical periods.

The *Emerging Views* paper concludes that an asset beta estimate of 0.30 is reasonable for Watercare. In doing so, the *Emerging Views* paper states that:

- the three UK water companies "operate under a regulatory framework closer to that applying to Watercare";[33]
- the UK water utilities "are therefore likely to provide the most relevant point of comparison for assessing the systematic risk faced by Watercare";[34]
- the seven water companies from the US differ from Watercare in important respects, including "regulatory arrangements, business mix, size, and leverage";[35]
- the sample of UK firms is small, "and while including US comparators increases the sample size, it introduces firms that are less similar";[36] and
- "to the extent that firms from the US face different types or levels of risk, their inclusion may pull the overall estimate away from what [the Commission] would expect for a regulated water utility such as Watercare."[37]

The *Emerging Views* paper concludes that, taking all these factors into account, the Commission should "place greater weight on the UK estimates", and that the Commission's emerging view is that it should adopt an asset beta estimate of 0.30 for Watercare.[38]

The Commission is not explicit about how much weight it has placed on UK estimates vis-à-vis the US estimates. However, Table 6 shows that averaging over the asset beta estimates for the UK comparators alone, over all three five-year estimation periods, produces a mean asset beta estimate of 0.30; every other averaging scenario (including any weight on estimates for the US

[33] *Emerging Views* paper, para. D.21.

[34] *Emerging Views* paper, para. D.23.

[35] *Emerging Views* paper, para. D.21.

[36] *Emerging Views* paper, para. D.23.

[37] *Emerging Views* paper, para. D.23.

[38] *Emerging Views* paper, para. D.24.

comparators) results in a higher mean estimate. Hence, it appears that the Commission has relied exclusively on just three UK firms to derive its asset beta estimate of 0.30.

Table 7: Mean asset beta estimates from Commission's proposed sample under different averaging scenarios

Averaging scenario	Mean estimate
All comparators, all periods	0.32
All comparators, two most recent periods	0.33
UK comparators only, all periods	0.30
UK comparators only, two most recent periods	0.31

Source: Frontier Economics analysis of Table D.4, Emerging Views paper.

2.5.2 Response to *Emerging Views* paper

The Commission's proposed approach of relying on just three firms, which represent a small subset of its comparator sample, and its rationale for doing so, is entirely inconsistent with its established practice.

In the 2023 IMs, the Commission did not derive its point estimate of asset beta for energy networks and airports by examining only a subset of its sample. For instance, the Commission's asset beta estimate for electricity networks was derived by calculating the mean weekly and four-weekly asset beta estimates *across all comparators* in the sample, over the estimation periods 2012 to 2017 and 2017 to 2022.

During the 2023 IM review, the Commission considered whether it should separate its energy comparator sample into subsamples for electricity and gas networks, but having undertaken statistical analysis ultimately rejected that notion.[39]

Notably, during the 2023 IM advisers to the Big Six EDBs, Oxera, proposed that the Commission exclude US energy networks from its energy comparator sample on the grounds that those companies operate under a different regulatory framework to New Zealand energy network suppliers regulated under Part 4 of the Act:

> *In practice, the NZCC could refine its sample of comparators by reviewing the characteristics and comparability of US-based utilities in more detail. These companies account for over 60 of the comparators in the NZCC's sample, and not all of them will be subject to the same type of regulatory regime as in New Zealand. Specifically, as was also noted by Dr Lally, some US-based utilities are subject to rate-of-return regulation rather than price cap regulation as in New Zealand. Removing*

[39] Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, para. 4.291.

some of the less comparable companies from the sample would reduce the NZCC's sample to a size more comparable to that of Ofgem and the AER.[40]

The Commission explicitly rejected that proposal stating that it was impractical to restrict the sample to only those companies regulated in a similar way to New Zealand suppliers, even though the Commission's energy sample also included Australian and UK energy networks.[41] The Commission went on to note that:

…in our view the most important characteristic of an energy comparator was whether it is an energy utility rather than an energy utility regulated in a comparable manner.[42]

Given that very clear statement, it is unclear why the Commission now considers that US water utilities should be included in its comparator sample but effectively be given no weight because they operate under a different regulatory framework to Watercare, and that UK water utilities should be favoured and given greater weight because they "operate under a regulatory framework closer to that applying to Watercare."

Why does the Commission not think that the most important characteristic of a water comparator is whether it is water utility rather than a water utility regulated in a comparable manner to Watercare?

The Commission also argues that the US water utilities are poor comparators to Watercare because they "differ in important respects, including regulatory arrangements, business mix, size, and leverage." All these things were true of US energy networks that the Commission resisted calls to exclude from its energy comparator sample in the 2023 IM review. It is unclear why the Commission now cites these factors as reasons why US water utilities should be excluded or given materially less weight.

The way in which the Commission proposes to weight asset beta estimates from different jurisdictions—principally the US estimates—is inconsistent with its past practice. The extensive and detailed process followed by the Commission to compile its comparator set is designed to identify a group of firms that are sufficiently comparable. If the Commission considered that the US utilities (or firms from other jurisdictions) are not adequately comparable to Watercare, why were they not screened out at the comparator selection stage? Having compiled its comparator sample, there is no reason for the Commission to undertake a further round of screening, *after* it has performed the beta estimation task.

Such an approach invites criticism that the Commission has been inconsistent in its approach, and reasoning, across industries. This undermines, rather than promotes, regulatory certainty.

Our view is that just three comparators is manifestly too small a sample with which to reliably estimate beta. It is well-known that beta estimates of individual companies are subject to a high

[40] Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, para. 4.230.

[41] Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, para. 4.231.

[42] Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, para. 4.231.

degree of statistical error and uncertainty. This statistical error tends to reduce as the sample size increases, because some of the error around the individual estimates is eliminated through averaging. The Commission could have no real confidence that an asset beta estimate derived from just three firms is a representative and statistically robust estimate, or simply an artefact of sampling error. The Commission could be more certain about its estimate as the size of its comparator sample increases (all else remaining equal). It is for this reason that the Commission has generally (and sensibly) erred towards larger, rather than smaller, comparators samples—even in the face of significant pressure from submitters to narrow its samples to a very small number of 'highly comparable' firms. If the Commission were to maintain the approach proposed in the *Emerging Views* paper, that would represent a very material and serious departure from its established approach. This, in turn, would undermine regulatory certainty and predictability.

To avoid these outcomes, we recommend that the Commission select its point estimate by averaging asset beta estimates across all firms within the water comparator sample, regardless of which market those firms are drawn from—noting that we have proposed an alternative sample to the Commission's in section 2.4.2.

Table 8 below presents asset beta estimates for each of the firms in our proposed alternative comparator sample. Based on that evidence, we propose an asset beta for Watercare of 0.41.

Table 8: Asset beta estimates for proposed comparators

Comparator	2011-2016		2016-2021		2021-2026	
	Weekly	Four-weekly	Weekly	Four-weekly	Weekly	Four-weekly
American States Water Company	0.408	0.291	0.356	0.245	0.324	0.398
American Water Works Company Incorporated	0.268	0.190	0.393	0.274	0.340	0.369
California Water Service Group	0.387	0.368	0.343	0.247	0.313	0.343
H2O America	0.383	0.317	0.417	0.452	0.201	0.212
Middlesex Water Company	0.379	0.328	0.519	0.385	0.368	0.404
York Water Company	0.412	0.297	0.552	0.356	0.300	0.317
Essential Utilities Inc	0.408	0.310	0.554	0.540	0.311	0.373
Pennon Group Public Limited Company	0.312	0.292	0.284	0.282	0.320	0.397
Severn Trent Public Limited Company	0.277	0.260	0.230	0.264	0.306	0.396
United Utilities Group Public Limited Company	0.264	0.252	0.250	0.251	0.288	0.375
Guangdong Investment Ltd					0.419	0.523
Cia Saneamento de Minas Gerais	0.344	0.482	0.591	0.612	0.563	0.712
Cia Saneamento do Parana Senepar	0.231	0.405	0.545	0.605	0.381	0.421
Cia Saneamento Basico de Estado Sao Paolo	0.414	0.370	0.706	0.768	0.663	0.593
Mean	**0.345**	**0.320**	**0.442**	**0.406**	**0.364**	**0.417**

Source: Frontier Economics.

2.6 Benchmark leverage

2.6.1 Proposed approach in *Emerging Views* paper

The *Emerging Views* paper proposes a benchmark leverage of 35%, derived by taking the mean leverage over all 10 comparators identified by the Commission, over all three five-year historical periods.[43]

2.6.2 Response to *Emerging Views* paper

This approach is consistent with the approach adopted by the Commission in the 2023 IMs. However, the *Emerging Views* paper is *internally inconsistent* in that it uses the full sample of 10 comparators to calculate the benchmark leverage, but only a subset of those comparators to estimate the asset beta.

Furthermore, the Commission uses inconsistent reasoning to support its *Emerging Views* on the asset beta and leverage. For instance, the *Emerging Views* paper cites differences in leverage between the US water utilities and Watercare as one reason to down-weight (effectively exclude from the sample) the US firms when estimating the asset beta.[44] Elsewhere, the *Emerging Views* paper cites the US firms' low leverage to justify its estimate of benchmark leverage:

> *Our estimated notional leverage of 35% is lower than the notional leverage used by other regulators. This largely reflects the relatively low debt levels of the US firms in our empirical sample. We do not consider this poses a practical issue, as it is internally consistent with our estimation methodology, being based on the average leverage of the comparator sample.*[45]

This provokes the question: why is it appropriate for the Commission to eschew the US firms when estimating the asset beta but explicitly use those same firms to estimate benchmark leverage and, moreover, cite their inclusion in the comparator sample as a justification of its estimate of benchmark leverage?

This apparent inconsistency is especially puzzling because the Commission's established method is that these two parameters—asset beta and benchmark leverage—should be estimated together, and consistently, rather than independently of one another. The Commission's longstanding approach is to set benchmark leverage equal to the average leverage of the same comparators used to estimate the asset beta. This avoids the so-called 'leverage anomaly', whereby the estimated WACC increases as leverage increases, whereas finance theory suggests that the WACC should be largely invariant to the changes in leverage.

As the Commission explained in the 2023 IMs:

> *One way of dealing with this anomaly would be to use a debt beta when converting the asset beta to equity beta. An alternative, which is our approach, is to assume the financial risk of the*

[43] *Emerging Views* paper, Table D.6.

[44] *Emerging Views* paper, para. D.21.

[45] *Emerging Views* paper, para. D.40.

benchmark firm is the same as the average financial risk of the comparator sample. In making this assumption, we avoid the complexity of converting asset betas to equity betas when notional leverage differs from the notional leverage of the comparator sample. This was discussed in more detail in our 2010 IMs.[46]

The inconsistency in the Commission's approach makes a material difference in this case. As noted above, averaging the leverage across all comparators and all three time periods produces an estimate of benchmark leverage of 35%. However, the average leverage over just the UK water utilities is materially higher—i.e., 50%. This would result in a re-levered equity beta estimate of 0.60 rather than the estimate of 0.46 proposed in the *Emerging Views* paper.

We recommend that, consistent with the Commission's established practice, it should:

- estimate the overall asset beta by calculating the mean asset beta across all firms in the water comparator sample; and
- set the benchmark leverage equal to the mean leverage across all firms in the water comparator sample.

Table 8 below presents the leverage estimates for each of the proposed comparators for each of the five-year historical periods used to estimate beta. Based on that evidence, we propose a benchmark leverage of 33%, which is slightly lower than the benchmark leverage of 35% proposed by in the *Emerging Views* paper.

Table 9: Leverage estimates for proposed comparators

Comparator	2011-2016	2016-2021	2021-2026
American States Water Company	23%	16%	21%
American Water Works Company Inc	44%	32%	31%
California Water Service Group	34%	28%	29%
H2O America	40%	28%	46%
Middlesex Water Company	32%	19%	23%
York Water Company	24%	17%	24%
Essential Utilities Inc	29%	25%	38%
Pennon Group Public Limited Company	43%	40%	54%
Severn Trent Public Limited Company	50%	52%	50%
United Utilities Group Public Ltd Company	53%	56%	53%
Guangdong Investment Ltd	n/a	n/a	31%

[46] Commerce Commission, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, para. 5.9.

Comparator	2011-2016	2016-2021	2021-2026
Cia Saneamento de Minas Gerais	42%	33%	33%
Cia Saneamento do Parana Senepar	32%	29%	34%
Cia Saneamento Basico de Estado Sao Paolo	36%	30%	27%
Mean	**37%**	**36%**	**31%**

Source: Frontier Economics.

2.7 Benchmark credit rating

2.7.1 Proposed approach in *Emerging Views* paper

The benchmark credit rating is used by the Commission to determine the size of the allowed debt premium for the suppliers it regulates. Typically, the higher the benchmark credit rating, the lower the allowed debt premium, all else remaining equal, reflecting the fact that investors typically demand a lower risk premium when lending to firms with higher creditworthiness.

The *Emerging Views* paper proposes a benchmark credit rating of A- (which is equivalent to a Moody's rating of A3). The Commission derives this benchmark credit rating by examining the average rating of those comparators in its proposed sample that have a public rating.

The *Emerging Views* paper confirms the Commission's established approach of specifying a "notional" (i.e., benchmark) credit rating, rather than adopting the supplier's actual credit rating, to avoid creating incentives for the supplier to finance itself imprudently (e.g., by increasing leverage excessively). The *Emerging Views* paper states that:

> *A notional credit rating of A- provides an adequate margin of safety with respect to water services. This margin protects against the possibility that economic downturns or shocks can lead to financial distress.*[47]

2.7.2 Response to *Emerging Views* paper

We broadly agree with the approach taken by the Commission in the *Emerging Views* paper. However, we caution that the Commission has relied on just seven firms (since three of the firms in the Commission's proposed comparator sample of 10 firms do not have published ratings) to determine the benchmark credit rating. This is a very small number and may not be representative of the credit rating of firms with similar operations and risks to that of Watercare.

Notwithstanding that point, we have applied the Commission's approach by examining the average credit rating of the nine rated firms in our alternative comparator sample. Table 10 below shows that our alternative comparator sample supports the Commission's proposed benchmark credit rating of A-.

[47] *Emerging Views* paper, para. D.44.

Table 10: Credit rating of comparator firms

Comparator	Credit rating
American States Water Company	A
American Water Works Company Incorporated	A
California Water Service Group	A+
H2O America	A-
Middlesex Water Company	A
York Water Company	A-
Essential Utilities Inc	A-
Severn Trent Public Limited Company	BBB
Cia Saneamento Basico de Estado Sao Paolo	BB
Average	**A-**

Source: Frontier Economics.

2.8 Term credit spread differential

2.8.1 Proposed approach in *Emerging Views* paper

The Commission's default approach is to set a cost of debt allowance assuming that the benchmark tenor of debt is five years. However, consistent with the Commission's established approach, the *Emerging Views* paper states that Watercare may propose a TCSD allowance if Watercare demonstrates that issuing longer term debt than five years would result in net additional financing costs relative to the benchmark tenor of debt.

Table 11 below (reproduced from the *Emerging Views* paper) presents the TCSD allowance for different tenors of debt proposed by the Commission.

Table 11: TCSD allowance proposed by the Commission

Original Tenor >	5	6	7	8	9	10+
Spread Premium[162]	0.000%	0.085%	0.170%	0.255%	0.340%	0.425%
Issuance cost adjustment[163]	0.00%	-0.03%	-0.06%	-0.07%	-0.09%	-0.10%
TCSD[164]	**0.00%**	**0.06%**	**0.11%**	**0.19%**	**0.25%**	**0.33%**

Source: Emerging Views paper, Table D.8, p. 119.

2.8.2 Response to *Emerging Views* paper

We agree with the Commission's proposal to provide Watercare with a TCSD allowance if it can demonstrate that it expects to issue debt with a weighted average original tenor in excess of five years.

We note that all economic regulators in Australia adopt a benchmark tenor of debt (or benchmark tenor for the debt premium) of 10 years (see Table 12 below). This reflects a consensus amongst Australian regulators that it is prudent for infrastructure businesses that own long-lived assets to issue long-term debt. As the Queensland Competition Authority (**QCA**) explained recently:

> *We consider calculating a 10-year cost of debt is consistent with the efficient debt financing practices of regulated infrastructure entities with long-lived assets. Issuing debt for longer terms, such as 10 years, can help manage refinancing risk. Calculating a 10-year cost of debt is also widely accepted and applied by Australian regulators, except for ERA in its energy decisions.*[48]

We note that the Economic Regulatory Authority (**ERA**) in Western Australia, cited by the QCA as an exception in this regard, is currently consulting on setting the entire cost of debt allowance (i.e., both the risk-free rate and the debt premium components) assuming a 10-year tenor.[49]

Table 12: Benchmark tenor of debt adopted by Australian regulators

Regulator	Benchmark tenor
AER	10 years
ESC	10 years
IPART	10 years
ESCOSA	10 years
ERA	5 years (risk-free rate), 10-years (debt premium)
OTTER	10 years
QCA	10 years
ICRC	10 years

Source: Frontier Economics analysis of QCA, Rate of return review, September 2024, Table 7, p. 45.

Watercare has instructed us to assume, for the purposes of this report, a weighted average original tenor of seven years.

[48] QCA, Rate of return review, September 2024, Table 7, p. 46.

[49] ERA, 2026 gas rate of return instrument review, Discussion paper, 23 October 2025.

2.9 WACC percentile

2.9.1 Proposed approach in *Emerging Views* paper

The Commission's established approach is to recognise that there is a range of uncertainty around its WACC estimates, since a supplier's true cost of capital cannot be observed; it can only be estimated with random statistical error. The *Emerging Views* paper explains that the midpoint of the WACC range represents the Commission's best, unbiased estimate of a regulated supplier's cost of capital (the statistical error being truly random), and that the Commission will only adopt a point estimate above the midpoint if it is satisfied that:

- the consequences of underestimating the WACC are materially more harmful to consumers than the costs of overestimating it; and
- applying an uplift to the allowed return can, when considered alongside other tools, effectively mitigate the risk of underinvestment, such that the increased consumer prices are justified.

The only industry for which the Commission currently applies an uplift in the WACC estimate above the midpoint is electricity lines businesses. For that industry, the Commission sets a cost of capital allowance in line with the 65th percentile of the estimated WACC range. The Commission has consistently concluded that the consequences of underinvestment in electricity networks (due to the cost of capital allowance being set below the true cost of capital) are likely to outweigh the harm to consumers of inadvertently setting the cost of capital above the true cost of capital, resulting on consumers paying more than they ought to. That is, because of the outsized impact of underinvestment in electricity networks, expected consumer welfare is maximised by setting the allowed return above the mid-point of the WACC range.

The *Emerging Views* paper concludes that a WACC uplift above the midpoint is not required in Watercare's case because:

- The cost of capital allowance is likely to have a weaker influence on investment levels for Watercare (compared to electricity networks) because Watercare cannot distribute dividends to its shareholder or raise additional external equity. The Commission argues that this means that the allowed return on equity does not function as a signal to attract or retain equity, as Watercare does not raise equity from capital markets and its shareholder does not face the conventional choice of deploying capital elsewhere. Investment decisions are therefore influenced by other factors, including the need to deliver on service quality requirements, the ability to raise debt on reasonable terms, and statutory obligations, rather than by the incentive of a financial return.[50]
- There are a number of "regulatory and institutional tools" that can address the risk of under-investment by Watercare. The tools cited by the Commission include:
    - Watercare's recent financial separation from Auckland Council, which the Commission considers should increase Watercare's borrowing capacity to fund long-term investment. The Commission's assumption appears to be that Watercare should finance most of its future investments using new debt;
    - Planning and reporting requirements under the Local Government (Water Services) Act 2025 and information disclosure under the Part 4 regime. The Commission notes that Watercare has a broad service chain. It is concerned that allowing a WACC uplift that applies to Watercare's entire RAB would be a blunt instrument that may be unnecessary

[50] *Emerging Views* paper, para. D.78.

if underinvestment is isolated to specific points within this chain. The Commission's view seems to be that greater transparency and reporting would be a more targeted way of identifying where underinvestment is occurring, so that those causes can be addressed more directly;

- Where financeability pressures arise, they can be addressed by adjusting the timing of cost recovery (e.g., by reprofiling cash flows) rather than by increasing the overall cost of capital allowance.

2.9.2 Response to *Emerging Views* paper

The first point to make in response to the Commission's analysis set out in the *Emerging Views* paper is that the cost to consumers of underinvestment is at least as significant in the case of Watercare as it is for electricity networks. In this regard:

- The *Emerging Views* paper cites evidence that water has an even lower income elasticity of demand (0.26) than electricity (0.28).[51] This indicates that water is at least as much a necessity or an essential service to consumers as electricity. All households and businesses are users of water – just as they are of electricity. In the same way that households and businesses cannot function properly without electricity, they similarly cannot function properly without reliable water services. Consequently, the economic cost of lost water consumption (e.g., due to service interruptions) is likely to be similar to the economic cost of lost consumption of electricity; and
- There is a significant need for new investment in Watercare's water network. This new investment is needed to renew assets and lift service quality and reliability. The Commission acknowledges that significant new investment will be required to support growth, asset renewal, and an improvement in service levels.[52] It follows from this that underinvestment in Watercare's network will result in significant economic loss to consumers.

In summary, the need to avoid underinvestment is just as great in the case of Watercare as it is for electricity networks. Consumer welfare is likely to be impaired by at least as much by underinvestment in the case of Watercare.

The Commission's established method for addressing the risk of underinvestment is to select an allowed return above the mid-point of its statistical range for WACC (the 67th percentile for electricity businesses). This directly addresses the source of potential underinvestment – where the allowed return is below the true cost of capital, new investment is not economically feasible (i.e., NPV<0). There is a risk of that outcome as the Commission cannot observe the true cost of capital and must make decisions using a statistically noisy *estimate*.

The *Emerging Views* paper does not argue that the risk of underinvestment is less important for Watercare but proposes that this risk might be addressed in a different way from the Commission's usual approach to this issue. Our responses to the Commission's suggestions in this regard are as follows:

- Before addressing the specifics of the alternative mechanisms that the Commission proposes for Watercare, we begin by noting that the departure from the Commission's standard approach for addressing the risk of underinvestment stands in direct contrast to the Commission's stated desire to apply its standard approach in all other aspects of the WACC. It is difficult to see how it can simultaneously be the case that Watercare's unique

[51] *Emerging Views* paper, para. D.31.

[52] *Emerging Views* paper, para. 3.42.

circumstances are not relevant to all other aspects of the WACC, but they are determinative in requiring a non-standard approach to underinvestment risk.

- The Commission suggests that, in the case of Watercare, it may be able to address financeability problems (that stand in the way of efficient investment) by simply reprofiling cash flows in an NPV-neutral way.[53] But this remedy can only address problems caused by the timing of regulated cash flows. It does not address the core problem of underinvestment caused when the allowed return is below the true cost of capital. The problem in that case is that the investment is not economically viable because it is NPV<0—or, in the Commission's parlance, the cost of capital allowance is not sufficient to promote financial capital maintenance. An NPV-neutral adjustment does not address this issue. Indeed, that is precisely why the Commission uses a percentile adjustment rather than cash flow reprofiling to address this issue for electricity networks. For the avoidance of doubt, we are not against the Commission using NPV-neutral reprofiling of allowed revenues to address financeability problems that arise due to cash flow timing mismatches (as discussed below in section 3). We simply make the point that NPV-neutral reprofiling of cash flows is not an appropriate solution when the problem is the risk of the allowed return is set below the true cost of capital (i.e., NPV<0).
- The Commission states that underinvestment could occur at any point in Watercare's supply chain and information disclosure would be a more targeted way of identifying where underinvestment is occurring.[54] It suggests that the risk of under-investment might be addressed via transparency and reporting requirements under the *Local Government (Water Services) Act 2025* and information disclosure under the Part 4 regime that identify where any underinvestment might be occurring. Again, this does not address the core issue – that an incentive to underinvest is created when the allowed return is set below the true cost of capital. Identifying the manifestations of that incentive is not a solution to it. Moreover, if this is a solution to the risk of underinvestment, why is it not also a solution to the risk of underinvestment in electricity networks? Some electricity networks that are regulated by the Commission (e.g., Transpower, Vector, etc.) have geographically large networks. Underinvestment could occur in different geographic regions, or in specific types of network assets, or in areas where there is network congestion. But the Commission (correctly, in our view) applies a WACC uplift to those networks' entire RABs to address the very source of this risk. We think a similar approach should be taken to Watercare, notwithstanding the reporting and information disclosures obligations that Watercare will be subject to.
- The Commission also suggests that the risk of underinvestment in the case of Watercare is mitigated by constraints including that (a) Watercare cannot raise new equity, (b) Watercare's equity holders cannot redeploy their equity elsewhere and (c) new finance will be raised in the form of debt, and the allowed return is higher than the cost of debt finance.[55] The essence of this argument is that Watercare is more likely (relative to electricity networks) to continue to invest even if the allowed return is below the true cost of capital (i.e., into NPV<0 investments) because its owners are constrained from acting in the manner of normal commercial investors. Our response to this argument is that:
  - The Commission has estimated a WACC that it considers to be appropriate compensation to normal commercial investors in light of the risks being borne by those investors. The Commission is right to take that approach because, as is well accepted in standard financial economics, the cost of capital of an investment is determined by the

[53] *Emerging Views* paper, para. D.90.

[54] *Emerging Views* paper, para. D.89.

[55] *Emerging Views* paper, para. D.78.

risks of the project, rather than by the identity of the party undertaking the project. As in every other case, the Commission has a statistically noisy estimate of the true cost of capital such that there is a positive probability that the true cost of capital is above the mid-point of the Commission's statistical range;

- If the Commission now considers that the return required by normal commercial investors is not the appropriate benchmark, it should be explicit about that. In particular, if the Commission considers that, due to the particular institutional setting for Watercare, the efficient level of investment will be made even if the allowed return is below the true cost of capital, the Commission should be explicit about this;
- The Commission should be explicit if it considers its role to be to set the allowed return on equity as low as possible while maintaining an efficient level of investment, even if that is below the commercial required return on equity – because Watercare has no option other than to invest. In this case, the Commission should be precise about:
  - Why it considers that to be the appropriate objective, and whether and how that would promote the Part 4 purpose; and
  - The maximum differential between the allowed return and the commercial required return on equity that would still result in the efficient level of investment. In particular, if the Commission considers that the efficient level of investment will still be made regardless of the allowed return on equity, why does it provide any allowed return on equity at all?

In summary, the Commission's argument on this issue:

- Is not that the risk of underinvestment is less important for Watercare consumers than for electricity consumers; and
- Is not that investors in Watercare require lower returns than those estimated using the Commission's usual approach.

Rather, the Commission's argument appears to be that Watercare will be forced (via various other mechanisms) to continue to invest even if the Commission sets the allowed return below the true cost of capital.

In our view, this would be a very significant departure from the Commission's usual approach. If such a change in approach is to be applied, that should be made explicit, along with an explanation of how this new approach is consistent with the Part 4 purpose.

We propose that the Commission should apply the same WACC percentile uplift for Watercare as it applies to electricity networks – the 65th percentile. This represents an application of the Commission's standard approach in the case where consumer welfare would be materially impacted by underinvestment.

Calculating a WACC percentile for the water industry

To derive the 65th WACC percentile for Watercare, we attempted to follow the approach taken in previous IM reviews. This involves obtaining estimates of the standard error of the estimates of key WACC parameters.

For standard errors of general WACC parameters we take the values as applied in the 2023 IM review. For the debt premium we apply a standard error of 0.15%, as per the 2023 IM review.[56]

[56] IM Review 2023 – Cost of Capital topic paper, December 2023, p.211.

Similarly, we apply to the estimate of the MRP a standard error of 1.50%, as per the 2023 IM review.[57]

To obtain the standard error of asset beta, it would be inappropriate to simply take the estimate of 0.12 applied for EDBs and GPBs used in the 2023 IMs, since that estimate related to the asset beta estimate for energy networks, which was derived using the Commission's energy network comparator sample. Instead, we sought to replicate the approach used by the Commission to obtain that estimate but applied to the water sector asset beta estimate. To do this we sought to repeat the approach taken by the Commerce Commission, which estimates the standard error of the asset beta point estimate. However, when doing so, we obtained negative variance estimates for certain samples. This is clearly non-sensical, as variance is non-negative.

Investigating the source of the anomaly, we determined that the source of the issue is the estimate of the parameter ρ (i.e., the correlation between asset beta estimates) used by the Commission in the 2023 IM review to derive its estimate of the standard error of the asset beta estimates for energy networks.

The Commission's approach assumes that individual comparator asset betas are correlated with each other, so that the standard error of the mean estimate must account for the correlation between each comparator. In particular, the Commission applies an approach defining the variance of the point estimate of asset beta as:

$$Variance = \frac{N+1}{N-1} Variance_1 - Variance_2(1-2\rho).$$

Where N is the sample size, $Variance_1$ is the variance of the N asset beta estimates (how dispersed are the N asset beta estimates) and $Variance_2$ is the average variance of the individual asset beta estimates (what is the typical statistical precision of the asset beta estimates?). The Commission applied a ρ of 0.20, representing the correlation between individual asset beta estimates. This captures the extent to which individual asset betas would tend to move in the same way (a key parameter to understanding the variance of the average asset beta estimate). This assumption resulted in the above equation being negative in some circumstances, when applied to the asset beta estimates for the firms in our comparator sample.

The Commission's estimate of ρ of 0.20 was obtained from Lally (2008).[58] In that paper, Dr Lally draws estimates of ρ from two academic papers: one from 1966, which implied a market wide estimate for ρ of 0.27;[59] and one from 1973, which implied an estimate of ρ for US utilities of 0.14.[60] Giving somewhat more weight to the more recent of the two estimates, Dr Lally concludes that an estimate of $\rho = 0.20$ would be reasonable. That is, the estimate of ρ adopted by the Commission in the 2023 IMs was based on just two academic studies of US firms (neither of which related to the comparator set the Commission actually used to derive its asset beta estimates), the most recent of which was published 50 years before the 2023 IMs.

In our view, the estimate of ρ adopted by the Commission in the 2023 IMs is unsuitable for the purposes of estimating the standard error of the point estimate of the asset beta for the water comparator sample, not least because adopting that estimate would yield the nonsensical outcome of a negative variance of the point estimate of the asset beta point estimate for the water comparators.

[57] IM Review 2023 – Cost of Capital topic paper, December 2023, p.211.

[58] Martin Lally, The weighted average cost of capital for gas pipeline businesses, 2008, p. 176.

[59] While King (1966) presents a value of 0.30, this is an average for 10 utilities. The estimate of 0.27 is obtained by Dr Lally by taking an average over all firms in King's sample.

[60] Dr Lally compares a market wide estimate of 0.12 to an estimate of 0.27 using all the firms in King's sample and compares the two to infer a value of 0.14.

As an alternative, we construct estimates of ρ by performing bootstrap analysis using data on the water comparators used to derive the water asset beta point estimate. To accomplish this, we take the comparator set, and all data between April 2011 and March 2026.

For each iteration we:

- randomly draw 1,282 dates (i.e., 5 years of weekly data);
- take the weekly returns index of each comparator as at each date;
- take the average leverage of each comparator over the dates selected;
- take the weekly returns index of the relevant market index as at each date; and
- obtain the asset beta estimate of each comparator accordingly.

This allows us to obtain asset beta estimates for each comparator based on a randomly drawn time period, but with consistent dates used across each comparator

We then repeat the process, so that we have 1,000 sets of asset betas, whereby each set of asset betas provides estimates of asset beta for each comparator based on the same observation period.

Examining the correlations of the asset beta estimates allows estimation of the ρ parameter. The average of the pairwise correlations is 0.5, suggesting that correlation of individual water asset beta estimates is stronger than the estimate 0.2 proposed by Dr Lally for utility firms.

We use our bootstrap estimate of ρ and repeat the calculation of the standard error of asset beta for the water comparator set, obtaining an estimate of 0.15 for our proposed sample.

These values are used as per the 2023 IMs approach to obtain a standard error of WACC of 1.03%. Taking the 65th percentile provides a WACC uplift of 0.385 standard errors, or approximately 0.40% above the midpoint WACC estimate.

2.10 Indicative WACC estimates for PQP28

Table 12 presents indicative estimates of each WACC parameter, consistent with the approaches proposed in the preceding sections of this report.

Table 13: Indicative estimates of WACC parameters and overall WACC

Parameter	Estimate	Basis for estimate
Risk-free rate	3.54%	Table 1 (Commission's standard approach).
Market risk premium*	5.25%	Table 1 (Commission's standard approach).
Asset beta	0.41	Section 2.5.2.
Benchmark leverage	33%	Section 2.6.2.
Equity beta	0.61	Re-lever asset beta using benchmark leverage.
Credit rating	A-	Section 2.7.2.
TCSD allowance	0.11%	Section 2.8.2.
Cost of equity	6.75%	Estimated using standard CAPM (section 2.3.2).

Parameter	Estimate	Basis for estimate
Cost of debt	4.81%	Table 1 (Commission's standard approach).
Vanilla WACC	6.11%	
65th WACC percentile	6.51%	Section 2.9.2.

*Source: Frontier Economics. Note: * Because we apply the standard CAPM rather than the SBL-CAPM, we express the Commission 7.0% estimate of the TAMRP by removing the adjustment for the average investor tax rate.*

3 Financeability

3.1 Establishment of Watercare's opening RAB

3.1.1 Proposed approach in *Emerging Views* paper

The Commission states that:

> *The initial RAB should be set at a value that, once input to the BBM, results in revenue that is high enough to continue to service the capital costs associated with its existing assets, and is consistent with Watercare maintaining an investment grade credit rating, but not so high that it gives rise to excessive returns.*[61]

The Commission considers two high level approaches to setting Watercare's initial regulatory asset base (**RAB**) that could achieve this objective:

- a physical initial RAB; and
- a financial initial RAB.

The Commission expressed a preference for the physical approach in the *Emerging Views* paper.[62]

Physical initial regulatory asset base

Under the physical initial RAB option, the Commission seeks to determine the value of Watercare's existing assets, based on actual historical costs, while excluding the value of assets that are funded by Infrastructure Growth Charges (**IGCs**), to exclude any funding for new infrastructure that customers have already contributed upfront.[63]

The physical initial regulatory asset base (net of the IGC contra asset) is estimated to be around $10 billion to $11 billion, based on indicative modelling provided by Watercare.

The asset lives associated with the physical initial RAB are intended to reflect remaining GAAP lives of the assets, with depreciation to be calculated using the straight-line real method, with indexation of the initial RAB for CPI changes over time.

Financial initial regulatory asset base

Under the financial initial RAB option, the Commission sets an initial RAB that will, in expectation, generate sufficient cash flows to satisfy funding requirements based on forecast capital expenditure, while allowing Watercare to maintain an investment grade credit rating.

---

61 *Emerging Views* paper, p. 36.

62 *Emerging Views* paper, p. 37.

63 This is accomplished in the illustrative model using an initial 'contra' IGC asset in combination with the physical asset RAB. This approach allows the depreciation profile of the contra asset to be varied to support financeability. The paper also notes that the IGC revenue could simply be netted off from the initial physical RAB.

This is accomplished by:

- Starting with an initial RAB equal to Watercare's forecast debt balance in 2028 (approximately $6.5 billion in the Commission's analysis) and adding an "equity buffer" that, together with the debt balance, would achieve a target net debt/RAB (i.e., leverage) ratio. For illustrative purposes the *Emerging Views* paper assumes 75% leverage, which the Commission considers is consistent with an investment grade rating.
- The initial RAB's remaining asset life is then adjusted to satisfy a target FFO/net debt range. For illustrative purposes the paper uses a target range of 9% to 13%, which the Commission considers is consistent with an investment grade rating.

Noting that this financial initial RAB does not strictly speaking reflect the physical assets used to provide regulated services, the Commission's view appears to be that the remaining life of the financial initial RAB need not align with the lives of physical assets, so that the value can be recovered via the depreciation allowance at a speed faster or slower than that implied by the regulatory depreciation computed using the physical RAB.

The Commission proposes that the financial initial RAB would not be indexed for changes to the CPI, in contrast to the RAB related to new investment, and the initial RAB under the physical approach. The Commission explains its rationale for this approach as follows:

> *Unlike for physical assets, where we try to maintain the real value of the RAB over time, we do not see a case for indexing a financial asset. So, if we preferred the financial option to set the initial RAB, we would not index it for changes in CPI inflation. The practical effect of this is to advance the recovery of the financial initial RAB by frontloading cash flows. This improves Watercare's financial sustainability in the early regulatory periods. This treatment is net present value (NPV) neutral so neither Watercare nor consumers (as a whole, over time) are impacted simply by the change in the timing of recovery of the financial initial RAB.*[64]

The *Emerging Views* paper estimates the financial initial RAB (net of the IGC contra asset) to be approximately $8 billion to $9 billion, based on indicative forecast debt provided by Watercare and target leverage of 75%.

Evaluation of financeability of initial RAB

Regardless of approach, the Commission's view is that the recovery of the initial RAB should generate sufficient cash flows to satisfy long-term financial sustainability (i.e., financeability), while accounting for future capital investment), with Watercare maintaining at least an investment grade credit rating.[65]

The Commission relies on two key metrics to assess financeability:

- leverage (net debt/RAB); and
- FFO/net debt.

The Commission considers that financeability would be satisfied if leverage is no more than 75%, and if FFO/net debt is in the range 9% to 13%.

[64] *Emerging Views* paper, para. 4.29.

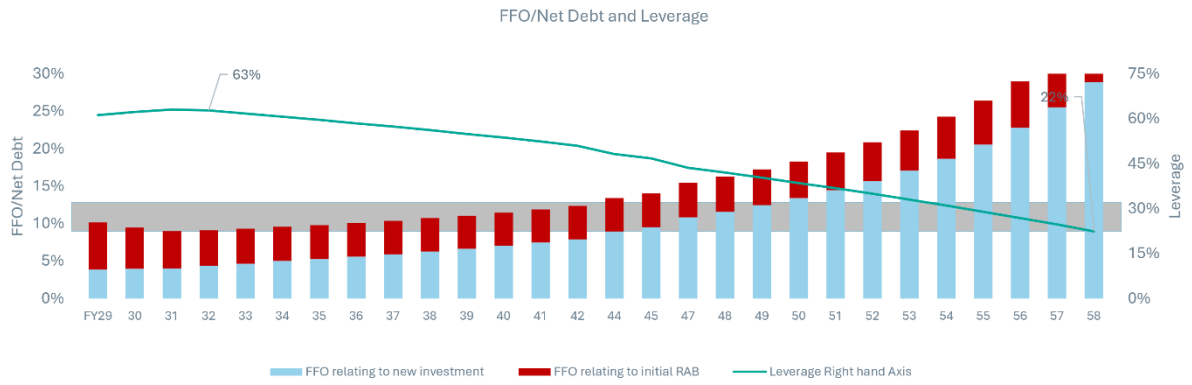
[65] *Emerging Views* paper, para. 4.47.

Using forecast capex and IGCs, along with inputs for the WACC allowance, interest expenses and specified asset lives, the Commission forecasts cash flows while letting net debt to evolve over time in a manner consistent with Watercare's financing restriction that its shareholder can provide no financial support, including new equity.

The Commission then evaluates the profile of the two key financeability metrics.

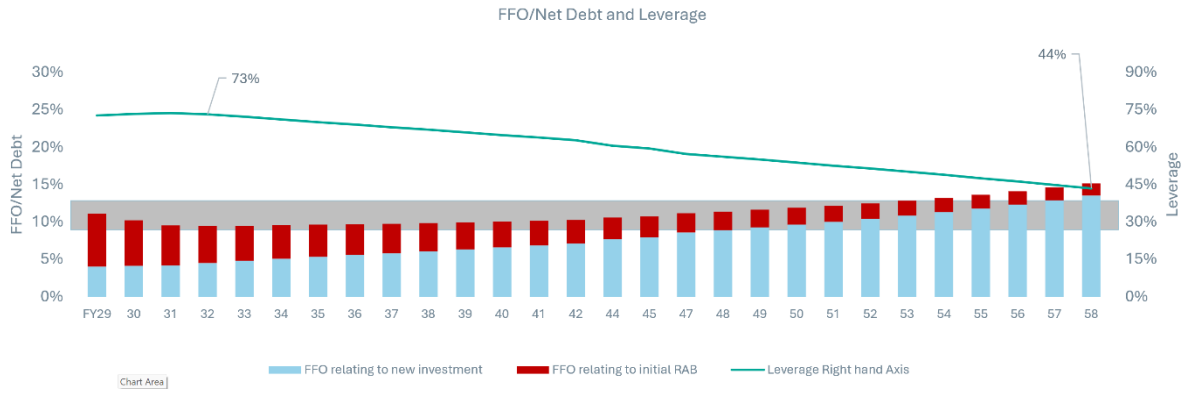
Under the approaches modelled in the supporting financial model published by the Commission alongside the *Emerging Views* paper,[66] both options provide outcomes within or exceeding the Commission's specified targets for leverage and FFO/net debt ratios. On that basis, the Commission considers that both options support Watercare's financial sustainability.[67] This is illustrated in Figure 1 and Figure 2 below.

Figure 1: Financeability – physical initial RAB



Source: Commerce Commission supporting Financial Model.

Figure 2: Financeability – financial initial RAB



Source: Commerce Commission supporting Financial Model.

66 https://www.comcom.govt.nz/assets/Documents/price-quality-path-for-watercare/Price-Quality-Path-for-Watercare-Emerging-Views-Paper-Supporting-Financial-Model-25-June-2026.xlsx.

67 *Emerging Views* paper, para. 4.70.

3.1.2 Response to *Emerging Views* paper

Selection of target ranges for leverage and FFO/net debt

Two financeability metrics are critical to establishing Watercare's initial RAB Under the approaches adopted in the *Emerging Views* paper: FFO/net debt and net debt/RAB (i.e., leverage). We agree that these two metrics are appropriate measures of financeability as they are two key metrics that Moody's focusses on when conducting rating assessments for Watercare.

The *Emerging Views* paper proposes a maximum leverage threshold of 75% and a target range of 9% to 13% for the FFO/net debt ratio. However, the Commission is very tentative when proposing these values. For example, the *Emerging Views* paper refers to the 75% leverage threshold as "illustrative",[68] and elsewhere states that the 75% leverage threshold and 9% to 13% FFO/net debt ratio "might be a suitable guide to financeability."[69]

It is unclear to us precisely how the Commission has arrived at these target values. The *Emerging Views* paper states that Moody's target leverage range for Baa rated businesses is 60% to 75%.[70] The 75% leverage threshold proposed by the Commission appears to be the value from the top of what the Commission suggests is Moody's target leverage range. The *Emerging Views* paper also states that Moody's target FFO/net debt range for Baa rated businesses is 11% to 18%.[71] However, both of those target ranges cited by the Commission are the ranges applied in Moody's rating methodology for regulated energy networks.[72]

The relevant target ranges specified in Moody's rating methodology for regulated water utilities with a broad Baa rating are:[73]

- Leverage – 55% to 70%; and
- FFO/net debt – 10% to 15%.[74]

The relevant target ranges specified in its rating methodology for regulated water utilities with a broad A rating (the relevance of which we discuss in the next sub-section) are:[75]

- Leverage – 40% to 55%; and
- FFO/net debt – 15% to 25%.

The target ranges in Moody's rating methodology for energy networks is not relevant to Watercare; the Commission should base its target values for leverage and FFO/net debt on Moody's rating methodology for regulated water utilities because that is the methodology that is used in practice by Moody's to conduct rating assessments for Watercare.

We are unclear why the Commission has proposed a target range of 9% to 13% for the FFO/net debt ratio as the bottom of that range sits below the target range specified by Moody's for Baa rated business (in both its rating methodology for regulated energy networks and its rating methodology for regulated water networks). That implies that under Moody's rating methodology an FFO/net debt ratio of 9% would be consistent with a sub-investment grade credit rating. Such

68 *Emerging Views* paper, p. 4.27.

69 *Emerging Views* paper, p. 46.

70 *Emerging Views* paper, para. 4.53.

71 *Emerging Views* paper, para. 4.54.

72 Moody's, Regulated electric and gas networks, Rating methodology, 13 April 2022, p. 6.

73 Moody's, Regulated water utilities, Rating methodology, 18 August 2023, p. 6.

74 Moody's refers to this target range for FFO/net debt explicitly in a recent rating opinion for Watercare.

75 Moody's, Regulated water utilities, Rating methodology, 18 August 2023, p. 6.

an outcome would be incompatible with the requirement under the Watercare Charter that Watercare must maintain a standalone investment-grade credit rating.

In regards the 9% to 13% range proposed by the Commission, the *Emerging Views* paper simply asserts that:

> *…the 9% to 13% ratio is largely consistent with the range of values Watercare uses in its Business Plan (9.7% to 11.4%). We note that Moody's range for a Baa rated business is 11% to 18%.*[76]

Whatever the Commission's rationale, we consider the 9% to 13% range irrelevant, and that (for the reasons we explain below) the proper range for consideration by the Commission is the 15% to 25% range specified by Moody's in its rating methodology for regulated water utilities.

Selection of target values

For reasons that are unclear to us, the *Emerging Views* paper specifies a target (maximum) value for leverage (i.e., 75%) but a target range for the FFO/net debt ratio (i.e., 9% to 13%). In our view, it would be clearer and less ambiguous if the Commission were to adopt a threshold *value* (rather than a range) for both metrics.

The question then is, how should the threshold values be chosen?

The principle that appears to have guided the Commission is that Watercare's initial RAB value should be set at a level that is just sufficient for it to maintain an investment grade credit rating, but no more. The Commission appears to focus on the need for Watercare to maintain an investment grade credit rating because this is a requirement under the Watercare Charter:

> *Under the Charter, Watercare must maintain a standalone investment-grade credit rating. Moody's considers anything above Baa 'investment grade' and has recently assessed Watercare to be a Aa3 rated business.*[77]

The *Emerging Views* paper also states that:

> *The initial RAB should be set at a value that, once input to the BBM, results in revenue that is high enough to continue to service the capital costs associated with its existing assets, and is consistent with Watercare maintaining an investment grade credit rating, but not so high that it gives rise to excessive returns. This promotes the long-term benefit of consumers by balancing the section*

[76] *Emerging Views* paper, para. 4.54.

[77] *Emerging Views* paper, para. 4.52.

52A(1)(a) and (d) limbs of the Part 4 purpose: incentivising Watercare to innovate and invest, but also limiting its ability to extract excessive profits.[78]

We agree with the notion that the initial RAB value should be set at a level that would allow Watercare to maintain an investment grade rating. However, we do not agree that the target should be a *bare* investment grade rating, as this would provide Watercare with no headroom to absorb unexpected shocks and short-term cash flow shortfalls. Such headroom is particularly essential in Watercare's case because its shareholder is prohibited by law from providing Watercare any financial support or capital.[79] Without such support from its shareholder, Watercare must rely on its own internal cash flows to ensure that it can meet its prudent and efficient expenditure requirements and service its debt obligations. It is therefore imperative for any prudent and efficient business in Watercare's circumstances to have sufficient cash flow headroom to manage unanticipated events. A RAB that delivers just sufficient revenue to support a bare investment grade rating would not provide Watercare with that essential headroom.

If the Commission sets an initial financial RAB, we propose that the initial RAB value should be set to target the benchmark credit rating adopted by the Commission for the purposes of setting Watercare's cost of capital allowance (rather than BBB- bare investment grade rating), as that represents the Commission's view of the appropriate credit rating for a benchmark efficient firm. Such an approach would have three benefits:

- it would be internally consistent because the initial RAB value would be set at a level that would be expected to deliver a stream of future cash flows consistent with the credit rating that the Commission considers the benchmark efficient firm should maintain. This would be more in keeping with the "benchmark efficient firm approach" the Commission adopts to regulate suppliers under Part 4 of the Act;[80]
- it would provide Watercare with the cash flow headroom it requires to manage unexpected shocks and short-term cash flow shortfalls, which is essential given its inability to access new equity capital; and
- it would satisfy the requirement in the Watercare Charter that Watercare maintain a standalone investment-grade credit rating.

The *Emerging Views* paper notes correctly that "Watercare receiving a credit rating below [the Commission's] assumed credit rating for estimating the debt premium" would represent a loss of financial sustainability.[81] Hence, as the Commission itself says, a situation where Watercare can only achieve a BBB- (i.e., bare investment grade) rating, while the Commission adopts an A- benchmark credit rating to set Watercare's cost of debt allowance, would "indicate a loss of financial sustainability."

The *Emerging Views* paper also makes clear that an A- benchmark credit rating would provide Watercare a "margin of safety" against unanticipated events:

We consider that the notional credit rating should reflect a prudent long-term level of exposure to credit default risk. The notional credit rating should be comfortably within an 'investment grade'

78 *Emerging Views* paper, para. 4.6.

79 Section 56a(1)(c), *Local Government (Auckland Council) Act 2009*.

80 *Emerging Views* paper, para. 5.8.

81 *Emerging Views* paper, para. 3.46.

credit rating as defined by the major credit rating agencies (eg, BBB- and above for S&P). A notional credit rating of A- provides an adequate margin of safety with respect to water services. This margin protects against the possibility that economic downturns or shocks can lead to financial distress. [82]

No such margin of safety would be available to Watercare if its initial RAB were set at a level that would, in expectation, allow it to achieve only a BBB- credit rating. The Commission states (correctly, in our view) in the excerpt above that it is not sufficient for the benchmark efficient firm to be barely investment grade; it should be "comfortably within an 'investment grade' credit rating." Hence, an approach that sets Watercare's initial RAB to allow it to achieve only a bare investment grade rating is not, in our view, an adequate or reasonable approach.

We therefore propose that the following threshold ratios should be used by the Commission to set Watercare's initial RAB value:

- Leverage: 55%; and
- FFO/net debt: 15%.

These values are at the bottom end of the broad A range for regulated water utilities under Moody's methodology and would therefore be consistent with an A- rating.[83]

Financeability outcomes under different options for the initial RAB and our proposed threshold ratios

As noted above, the *Emerging Views* paper considers two options for setting the initial RAB value:

1. an initial physical RAB value, with indexation applied to that initial value going forward; and
2. an initial financial RAB value, with no subsequent RAB indexation applied.

A third option would be:

3. an initial physical RAB value, with no subsequent RAB indexation applied.

The *Emerging Views* paper appears to rule this third option out but, as we explain below, there are sound reasons to consider that as a viable option, and past precedent for such an approach. We therefore consider each of these options below.

The Commission concluded that its estimates of both the physical initial RAB and the financial initial RAB would be "within or above [its] range for the leverage and FFO/net debt ratios" and, therefore, both options support Watercare's financial sustainability. However, that conclusion was based on a comparison against target ratios consistent with only a BBB- rating.

The first option above involves setting the initial RAB using Watercare's actual historical costs. The key benefit of this approach is that the initial asset value reflects the investments that Watercare has actually made historically and which are yet to be recouped. The asset value is also supported by financial records and is not underpinned by modelling assumptions to which the initial asset value would be sensitive.

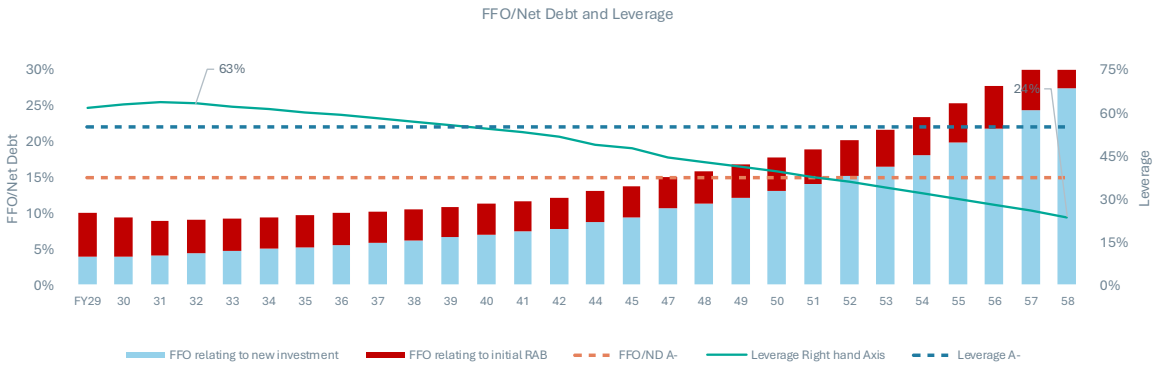
Figure 3 below shows that under that approach Watercare's forecast leverage remains above the 55% threshold (consistent with the Commission's proposed benchmark A- rating) until FY2039, and its forecast FFO/net debt ratio would remain below the 15% threshold (consistent with the Commission's proposed benchmark A- rating) until 2053. This suggests that a benchmark efficient

[82] *Emerging Views* paper, para. D.44.

[83] Moody's, Regulated water utilities, Rating methodology, August 2023, p. 6.

firm targeting an A- credit rating (as the Commission has proposed) would not be financeable under the Commission's estimated physical initial RAB.

Figure 3: Financeability – physical initial RAB with RAB indexation – Threshold ratios consistent with A- rating



Source: Frontier Economics analysis of Commerce Commission supporting Financial Model.

The second option would involve grossing up Watercare's forecast net debt in 2028 (approximately $6.5 billion in the Commission's analysis) such that the business commences the first regulatory period at a target leverage ratio. Whilst the Commission adopted a target leverage ratio of 75%, our view is that a threshold leverage ratio of 55% would be more commensurate with the A- benchmark credit rating proposed by the Commission. Adopting a threshold leverage ratio of 55% would result in an opening RAB of approximately $12 billion, which is similar to the physical initial RAB value proposed by the Commission.

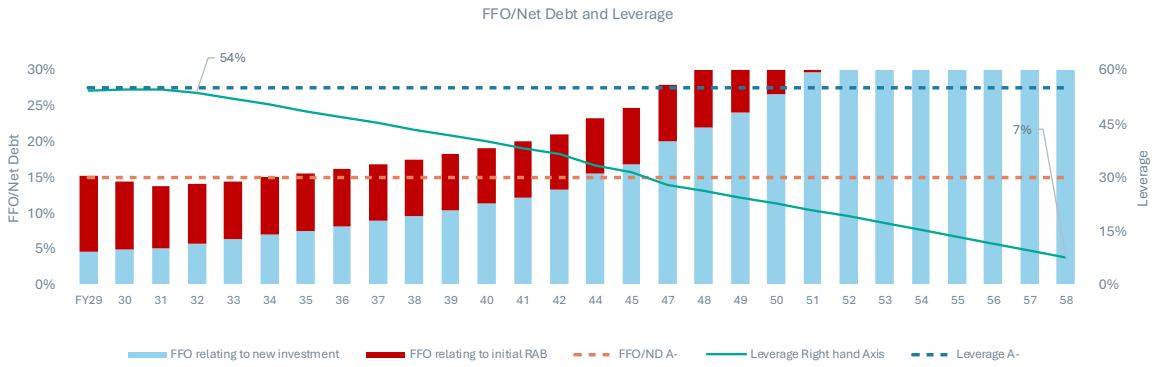
However, unlike the physical initial RAB, the Commission has proposed that no RAB indexation would apply to the financial initial RAB;[84] only the value of assets added post-June 2028 would be indexed to changes in inflation. As the Commission notes correctly, the practical effect of applying no indexation to the financial initial RAB would be to frontload recovery of the RAB (in an NPV-neutral) way, thus improving the business's financeability.

The effect of this can be seen in Figure 4 below, which shows that Watercare's forecast leverage is initially 55% (by construction) but declines as the initial RAB is depreciated and Watercare's initial debt is retired gradually. Applying no indexation to the financial initial RAB allows Watercare's debt to be retired more quickly and brings forward some cash flows in the early years. This results in an FFO/net debt ratio close to 15% in the early years, and an improvement above this threshold by 2035 (rather than by 2047, as in Figure 3) since Watercare's debt can be paid down more quickly.

The reason the FFO/net debt ratio is forecast to be relatively high in later years (both in Figure 3, which represents the Commission's proposed initial RAB value, and in Figure 4) is because Watercare is prohibited from paying dividends. This means that retained earnings accumulate within the business over time and are used to finance new investments. This, in turn, means that there would be a diminishing need for new debt over time. As the denominator of the FFO/net debt ratio declines, the ratio will increase, all else remaining equal.

84 *Emerging Views* paper, para. 4.29.

Figure 4: Financeability – financial initial RAB without RAB indexation – Threshold ratios consistent with A- rating



Source: Frontier Economics analysis of Commerce Commission supporting Financial Model.

The main benefit of the financial initial RAB method, as we have modelled it above, is that it is expected to produce cash flows in almost all years that support an FFO/net debt ratio commensurate with the Commission's proposed A- benchmark credit rating.

It is worth emphasising that:

- The financial initial RAB approach (assuming a 55% threshold leverage ratio) produces a very similar initial RAB value to the Commission's estimate of the physical initial RAB;
- Both the Commission's estimate of the physical initial RAB (Figure 3) and the financial initial RAB approach (Figure 4) result in Watercare's forecast FFO/net debt ratio improving above 15%. The FFO/net debt ratio under the financial initial RAB approach starts out very close to 15% and is expected to increase above that level by 2035. By contrast, the FFO/net debt ratio is expected to remain well below 15% in the initial years under the Commission's estimate of the physical initial RAB, and to increase above that level only by 2047; and
- The main reason why cash flows and financeability under the financial initial RAB approach are stronger in the early years than under the Commission's estimate of the physical initial RAB is because (as the Commission has proposed) no indexation is applied to the financial initial RAB, whereas indexation is applied to the physical initial RAB.

The third option, which is not considered in detail by in the *Emerging Views* paper, would be to set the physical initial RAB value (as above), but then apply no RAB indexation to that initial value for a period of time. The *Emerging Views* paper explains that the Commission's usual approach is to index the physical RAB value for inflation as this "maintains the real value of the RAB over time."[85] We note that notwithstanding the Commission's established approach of promoting real financial capital maintenance, between the establishment of the 2010 IMs and the establishment of the 2023 IMs, the Commission applied no indexation to Transpower's physical RAB, in large part to support Transpower's financeability as it delivered a large backlog of network investments.

The 2010 IMs explained the Commission's rationale for applying no indexation to Transpower's RAB as follows:

> *Transpower is planning to invest over $3 billion in upgrading and renewing the transmission network over the next five years, which will more than double the value of Transpower's RAB. This*

[85] *Emerging Views* paper, para. 4.24.

level of proposed investments is significantly larger than any of the EDBs in both an absolute and relative sense. In addition, unlike the EDBs, a significant portion of Transpower's planned investment programme involves expenditures being incurred a number of years in advance of commissioning. The level of Transpower's investments will result in it having, relative to other lines businesses, high investment programme funding requirements…

updating the RAB value using an un-indexed approach will, given the likely age structure of Transpower's asset base, be likely to lead to higher revenues for Transpower over the near term. This level of revenue will be likely to be better matched to Transpower's investment needs…

Some of the above factors might be more relevant over the short to medium term than over the long-term (e.g. because of Transpower's current tranche of investment). In the case of EDBs, the Commission considers the greater protection against inflation risk that is afforded by CPI-indexation is sufficient reason to prefer such an approach over an unindexed approach. In Transpower's case this factor is currently outweighed by the factors discussed above. In the longer term, some of the differences between Transpower and EDBs might become less significant, in which case consideration of greater alignment in some of the approaches for electricity distribution services and electricity transmission services might be warranted.[86]

In the 2010 IMs, when the Commission first decided to apply no indexation to the Transpower's RAB, the Commission did so fully cognisant that it was taking a different approach to the approach taken for EDBs. The Commission acknowledged explicitly that non-indexation of the RAB would not preserve the real value of Transpower's RAB, but concluded that this was outweighed by the benefits of strengthening Transpower's financeability as it completed its program of catch-up investment:

In the case of EDBs, the Commission considers the greater protection against inflation risk that is afforded by CPI-indexation is sufficient reason to prefer such an approach over an un-indexed approach. In Transpower's case this factor is currently outweighed by the factors discussed above. In the longer term, some of the differences between Transpower and EDBs might become less significant, in which case consideration of greater alignment in some of the approaches for electricity distribution services and electricity transmission services might be warranted.[87]

In our view, there is a strong case for a similar treatment to be applied to Watercare, given that:[88]

- Watercare is expected to undertake, over the next few regulatory periods, a major investment program in long-lived assets;

[86] Commerce Commission, Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, para. 3.59.

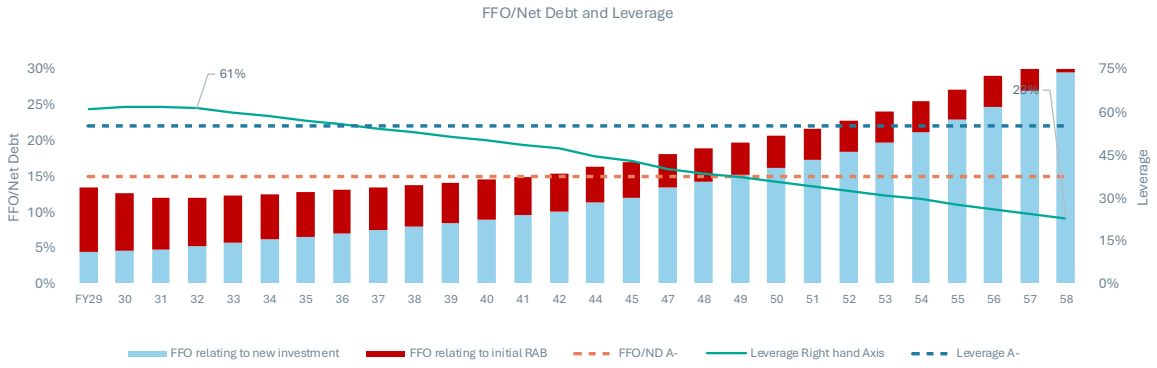
[87] Commerce Commission, Input Methodologies (Transpower) – Reasons paper, December 2010, para. 4.3.13.

[88] In any event, we consider that there is a compelling case to apply no indexation to at least the debt portion of the RAB, given that all businesses in New Zealand issue nominal debt and therefore incur nominal interest expenses. Applying no indexation to the debt portion of the RAB will deliver the regulated supplier a nominal return on debt allowance in each regulatory period, thus providing a closer match between the regulatory allowance and the firm's

- The long-lived nature of the new assets that Watercare expects to invest in will mean a relatively slow recovery costs, relative to its forecast debt obligations, particularly in the early years; and
- Watercare has no ability to manage financeability problems on its own, given that it cannot raise new equity finance and because its revenues will be capped by regulation.

Figure 5 below presents the financeability outcomes under this third option. In comparison to the financeability under the indexed physical RAB, the unindexed physical RAB results in stronger financeability with higher FFO/ND and lower leverage earlier. The higher initial cash flows support financeability both initially and over time as less cash is used to pay debt interest. It should be noted that both options initially fail to meet the targets for an A- credit rating, but to a lesser extent than if indexation were to be applied.

Figure 5: Financeability – physical initial RAB without RAB indexation – Threshold ratios consistent with A- rating



Source: Frontier Economics analysis of Commerce Commission supporting Financial Model.

nominal debt service obligations. We note that Ofgem in Great Britain has recently adopted this approach, whereby the benchmark portion of fixed rate debt in the RAB will no longer be indexed. Ofgem, RIIO-3 Final Determinations – Finance Annex, 4 December 2025.

Table 14 below compares the present value (**PV**) of BBAR under the alternative options for setting the initial RAB value. Table 13 shows that under the physical RAB approach, applying indexation or leaving the RAB unindexed results in similar regulated revenues over long horizons (i.e., 30 years or more), since indexation simply alters the speed of the recovery of the RAB. The unindexed physical RAB approach will deliver slightly higher revenues over a 10-year horizon than the indexed physical RAB approach, due to the front-loading of cost recovery when no indexation is applied. This would provide Watercare with greater cash flows in earlier years, during which a large capital investment program is forecast and the risk of a financeability problem is likely to be greatest. The financial indexed RAB approach (final column) delivers slightly higher revenues over all horizons, since the financial initial RAB is slightly higher (approximately $12 billion) than the physical initial RAB (approximately $11 billion).

Table 14: Comparison of the PV of BBAR under the different options for setting the initial RAB value

	Physical, Indexed	Physical, Unindexed	Financial, Unindexed (55% leverage threshold)
PV of BBAR (50 years) - based on WACC discount rate	$38,986	$38,818	$40,046
PV of BBAR (40 years) - based on WACC discount rate	$34,465	$34,195	$35,302
PV of BBAR (30 years) - based on WACC discount rate	$27,951	$28,214	$29,464
PV of BBAR (10 years) - based on WACC discount rate	$10,638	$11,678	$12,410

Source: Frontier Economics analysis of Commerce Commission supporting Financial Model.

3.2 Ongoing financing of capital expenditure

3.2.1 Proposed approach in *Emerging Views* paper

As noted above, Watercare's shareholder is prohibited by law from providing it with any financial support or capital. In practice, this means that Watercare has no access to new equity capital. No other supplier subject to PQP regulation under Part 4 of the Act operates under such a constraint.

The *Emerging Views* paper does not acknowledge this important financial constraint on Watercare, let alone explain how the Commission intends to address it when setting Watercare's allowed revenues.

However, in the Commission's supporting financial model, all forecast capital expenditure (**capex**) is assumed to be financed almost entirely through the issuance of new debt, once the modest amounts of retained earnings available to Watercare have been exhausted. That is, the Commission's modelling seems to recognise that Watercare cannot raise new equity from its shareholder to finance capex.

3.2.2 Response to *Emerging Views* paper

The Commission should maintain its conventional constant benchmark leverage approach

The Commission's established approach is to set a regulated supplier's allowed revenues using a benchmark efficient firm approach. This involves setting allowances for a hypothetical efficient firm that is assumed to maintain an efficient capital structure in line with the benchmark leverage ratio used to set the cost of capital allowance.

In practice, this means that the benchmark efficient firm modelled in the Building Block Model (**BBM**) used to set revenue allowances is assumed to maintain a constant level of leverage in line with the benchmark leverage ratio used to set the cost of capital allowance, in each year of the regulatory period.

This is true regardless of how the initial RAB was determined. For example, the Commission may set an initial financial RAB assuming a leverage ratio of 55%. Once the initial RAB value has been determined, the Commission would draw a 'line in the sand' and assume that the benchmark efficient firm maintains a constant leverage ratio in line with the benchmark leverage used to set the cost of capital allowance.[89]

This is achieved by assuming that all capex is financed in line with the efficient capital structure determined by the Commission. For instance, suppose the Commission adopted a benchmark leverage ratio of 33% to set the cost of capital allowance (as we have proposed above). Then, every $100 of capex that enters the RAB is assumed to be financed by $33 of new debt and $67 of new equity.[90] This would ensure that the benchmark efficient firm maintains a constant leverage of 33% in every year of the regulatory period in the BBM.

The difficulty in the present case is that a benchmark efficient firm in Watercare's circumstances would have no way of raising new equity. Any business has access to only three sources of funds:

- equity;
- debt; and
- retained earnings.

If the business cannot issue new equity, then any new investment must be financed through new borrowing or retained earnings.

If the benchmark efficient firm is restricted to finance capex mostly through borrowing (for example due to low retained earnings), then whenever the firm's RAB grows (including due to a significant capex program) its borrowing will increase and the Commission's constant leverage assumption in the BBM will be violated. If the capex program is sufficiently large and financed mostly through new debt, the leverage of the benchmark firm could in principle increase to levels that create a financeability problem that could ultimately trigger a rating downgrade.

A prudent business would seek to avoid such outcomes so would most likely cease investing to avoid a situation where its credit rating is imperilled. This may mean that prudent and efficient investments that would promote the long-term benefit of consumers are delayed or never occur at all. Such an outcome would clearly be at odds with the Part 4 purpose.

It is for this reason that it would be untenable to require in the BBM that a benchmark efficient firm facing Watercare's restrictions on raising new equity will finance capex largely by issuing new debt. That would be a significant departure from the Commission's established approach for all other suppliers it regulates under Part 4 of the Act. For no other industry subject to PQP regulation does the Commission allow the leverage ratio in the BBM to drift away from the benchmark leverage ratio over time (e.g., within a regulatory period).

Rather, the Commission should maintain its established approach of ensuring that the benchmark efficient firm maintains constant leverage in the BBM. If the firm cannot raise new equity to finance capex, the only way for it to maintain a constant leverage ratio in the BBM is for it to generate sufficient retained earnings to take the place of the new equity that would otherwise be required. For example, to maintain a constant benchmark leverage ratio of 33%, every $100 of RAB increase

[89] This is consistent with the Commission's established practice. For instance, the Commission set the initial RAB values of the lines businesses it regulates under Part 4 of the Act using the optimal deprival value (**ODV**) method in its 2010 IMs. Thereafter, the Commission assumed that the benchmark efficient lines business maintained a constant leverage ratio in line with the benchmark leverage used to set the WACC allowance, regardless of the actual leverage ratios of each lines business, or the method and assumptions used to set the initial RAB.

[90] Strictly speaking, this would be $33 of new debt for each $100 increase in the RAB.

(i.e., due to capex) would need to be financed using $33 of new debt and $67 of retained earnings (i.e., surpluses).

The only way the Commission's constant leverage ratio assumption can be satisfied is if there is an adjustment (i.e., an increment or a decrement) to Watercare's allowed revenues that ensures it has just sufficient retained earnings over the regulatory period to replace the equity capital that would be required to finance the forecast capex over that period. We refer to this revenue adjustment as a *customer capex contribution*, which can be positive or negative. The role of the customer capex contribution would be to provide Watercare with just sufficient regulated revenue over the period to undertake the prudent and efficient capex allowed by the Commission, while maintaining a constant level of leverage in each year.

At a high level, setting the customer capex contribution would involve two steps:

- First, set the building blocks allowable revenue (**BBAR**) in the usual way; and
- Then solve for the additional revenue that would be necessary to for the benchmark efficient firm to maintain a constant leverage ratio in the BBM.

The customer capex contribution will tend to be:

- **Positive** when the RAB is forecast to grow due to a large capex program because more 'equity' is required to finance the real RAB increase; and
- **Negative** when the RAB is forecast to decline (because less 'equity' is needed within the business).

Given the financing constraints faced by Watercare, consumers must play the role of 'equity holders'. When the customer capex contribution is positive, consumers would be contributing additional funds to enable the forecast prudent and efficient capex to occur. When the customer capex contribution is negative, consumers would receive rebate via reduction to the BBAR and the resulting reduction in prices.

The detailed steps involved in computing the customer capex contribution are as follows:

1. For the first year of the forthcoming regulatory period, determine the forecast opening RAB value (RAB_t), benchmark leverage ratio ($Leverage$) and forecast rate of inflation ($Inflation$), prudent and efficient capex ($Capex_t$), regulatory depreciation (Dep_t).
2. Evaluate the forecast closing benchmark debt value calculated as: $Leverage \times (RAB_t \times Inflation + Capex_t - Dep_t)$.[91]
3. Evaluate the forecast closing debt value by requiring capex to financed via retained earnings and issuance of new debt.
4. If the forecast closing debt value is above the forecast closing benchmark debt value, increase the customer capex contribution. This would increase retained earnings and be subtracted from capex (and so will lead to reduced regulatory depreciation and return on capital allowances), until the forecast closing debt value is equal to the forecast closing benchmark debt value
5. Similarly, if the forecast closing debt value is below the forecast closing benchmark debt value, decrease the customer capex contribution until the forecast closing debt value is equal to the forecast closing benchmark debt value.

It is essential to understand that the customer capex contribution is symmetric as it ensures that the benchmark efficient firm has just sufficient revenue within each regulatory period to ensure that it has the funds to undertake the forecast capex the Commission accepts is prudent and

[91] Note, $Inflation = 0$ if the Commission decides not to index the initial RAB value.

efficient. If the BBAR is more than sufficient to ensure this, some allowed revenue is returned to consumers via a reduction in the BBAR for that period.

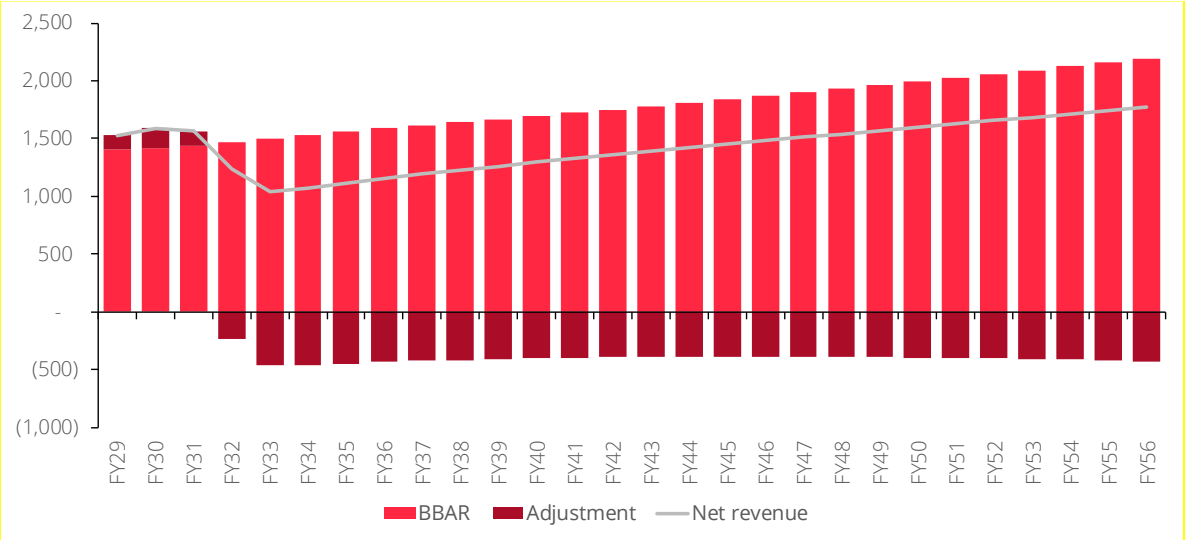
Consumers will not pay twice for the same regulated assets. The amounts contributed by customers via the customer capex contribution would not enter the RAB and be recovered again by Watercare. Rather, when the customer capex contribution is positive, consumers would effectively pay a bit more upfront for the assets than would be the case if Watercare could access new equity finance.

We recognise that this is less ideal than the usual approach applied by the Commission when setting allowed revenues for other suppliers under Part 4 of the Act. However, Watercare's circumstances—in particular its inability to raise new equity—are fundamentally different to those faced by other suppliers regulated under Part 4 of the Act. The Commission should not simply assume away those circumstances (e.g., by assuming that Watercare can raise new equity finance when in fact it cannot). Nor should the Commission assume that it would be prudent for the benchmark efficient firm to finance its capex using mostly debt. This would be a fundamental departure from its well-established approach of setting allowed revenues on the basis that the benchmark efficient firm will always maintain constant leverage in line with the efficient capital structure identified by the Commission. Abandoning the Commission's constant benchmark leverage approach could, in principle, result in a situation where the benchmark efficient firm's leverage increases to a level that causes a serious financeability problem, or a situation where the benchmark efficient firm invests less than the prudent and efficient level of capex to avoid such an outcome. Neither of these outcomes would promote the Part 4 purpose.

Indicative outcomes under a customer capex contribution approach

We have incorporated into the Commission's supporting financial model the customer capex contribution approach described above. Figure 6 plots the total (unsmoothed) real allowed revenues to Watercare if a customer capex contribution were applied. As the figure shows, in some years the total allowed revenue is greater than the BBAR (because the customer capex contribution is positive) and in other years the total allowed revenue is lower than the BBAR (because the customer capex contribution is negative). However, the total allowed revenue in every year is just sufficient to ensure that Watercare will be able to deliver the forecast capex in that year.

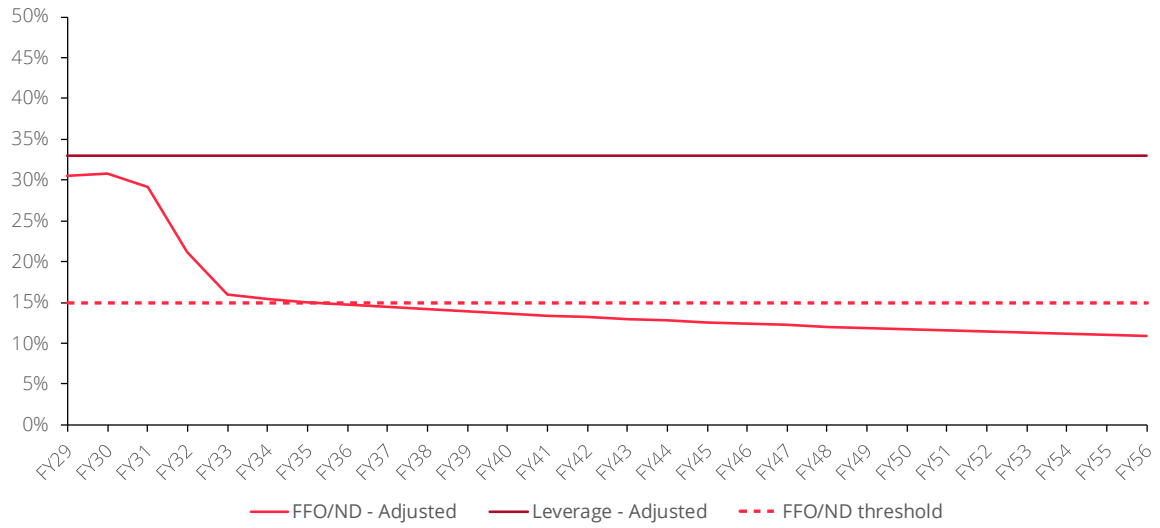
Figure 6: Allowed real revenues ($FY2029) under a customer capex contribution approach



Source: Frontier Economics.

Figure 6 plots the indicative financeability outcomes under the customer capex contribution approach we have proposed. This figure assumes that the Commission sets a financial initial RAB consistent with 55% leverage. We assume that, thereafter, the Commission adopts its established approach of setting the BBAR assuming that the benchmark efficient firm maintains a constant level of leverage in line with the benchmark leverage ratio of 33%. In addition, we assume that the Commission sets Watercare's total allowed revenues by applying the customer capex contribution amounts presented in Figure 6.

Figure 7: Leverage and FFO/net debt outcomes under a customer contribution approach



Source: Frontier Economics.

Figure 7 shows that the FFO/net debt ratio is expected to be relatively high in the early years because Watercare requires a positive customer capex contribution, which would provide Watercare with additional cash flows. Note that the purpose of the customer capex contribution is not to bolster Watercare's financeability. Its main purpose is to ensure that Watercare has sufficient funds to deliver the forecast prudent and efficient capex. However, when the customer capex contribution is positive, that provides Watercare with additional cash flows (which increases its funds from operations) and allows Watercare to avoid some new borrowing (which keeps its net debt at a level that maintains the benchmark level of leverage). These two factors have the second order effect of improving Watercare's financeability.

Figure 7 also shows that from FY2036 onwards the FFO/net debt ratio falls below the 15% Moody's threshold for an A- rated business. The main reason for this is while the benchmark efficient firm is assumed to have relatively modest leverage (i.e., 33% in each year), so that the net debt amount in the denominator of the FFO/net debt ratio is relatively low, the negative customer capex contributions reduces its funds from operations (i.e., the numerator of the ratio). The next section discusses how the Commission could ensure that the benchmark efficient firm can continue to support the benchmark credit rating at the benchmark level of leverage (i.e., remain financeable) on an ongoing basis.

3.3 Maintaining ongoing financeability

3.3.1 Proposed approach in *Emerging Views* paper

The *Emerging Views* paper acknowledges that even if Watercare's initial RAB is set having regard to financeability considerations, financeability problems can emerge. The *Emerging Views* paper goes

on to explain that the regulated supplier would ordinarily be expected to manage such financeability problems by changing its dividend policy or by securing additional equity:

> *...we note that while financial sustainability considerations have been considered in establishing the initial RAB and revenue path, financeability risks may also emerge during the period. This may include uncertainty associated with revenue from IGCs. Financeability issues are typically something firms are expected to manage themselves in other sectors (eg, through changing dividend policies and injecting equity if necessary).*[92]

The *Emerging Views* paper notes that the Commission has a number of 'tools' to improve the financeability of the benchmark efficient firm, including:[93]

- accelerating its depreciation allowance to bring forward regulated cash flows from future regulatory periods;
- smoothing revenues either within or between regulatory periods when setting revenue limits; and
- reopeners to adjust revenue limits.

However, the *Emerging Views* paper indicates that the Commission would need to see evidence of a sustained financeability problem before it takes any of these actions:

> *If the FFO/net debt ratio falls below the lower bound of our indicative range **for a sustained period over the forecasting horizon**, this may indicate a financeability issue. As noted in paragraph 3.50, we have a number of levers to address financeability issues.*[94] *[Emphasis added]*

And:

> *There would need to be clear evidence of material and persistent financeability pressure that could affect service delivery or efficient investment.*[95]

3.3.2 Response to *Emerging Views* paper

It is encouraging that Commission recognises that an efficient benchmark business may face financeability problems even if its initial RAB is set at a level that is intended to avoid such problems. No party, including the Commission has perfect foresight. Unexpected events can arise

92 *Emerging Views* paper, para. 6.47.

93 *Emerging Views* paper, para. 3.50.

94 *Emerging Views* paper, para. 4.59.

95 *Emerging Views* paper, para. 6.47.

that produce a cash flow shortfall that gives rise to a temporary financeability issue. The *Emerging Views* paper identifies some examples of these events.

It is not unusual for regulated water businesses to face temporary financeability problems. Such businesses sometimes make very large, lumpy investments in long-lived assets. This typically requires the firms to increase their debt obligations significantly. However, the long-lived nature of these investments means that the recovery of the costs of the investments (through the depreciation allowance) occurs slowly. This 'slow money' problem can create temporary shortfall in the firms' cash flows, relative to its debt obligations—thus creating a financeability problem.

Regulated suppliers can also face large, unanticipated events—such as natural disasters and other catastrophic events beyond the supplier's control—that require major expenditure, to restore services, that are not provided for within revenue allowances to address. The *Emerging Views* paper proposes to allow limited in-period adjustments to the BBAR (e.g., reopeners) to deal with such events. We support the proposal for such mechanisms as they allow for the recovery of unexpected, but prudent and efficient costs incurred by suppliers.

However, we note that it can take years for such adjustments to be approved by the Commission. By way of example, the Commission finalised its decision on Transpower's Redclyffe major capex project proposal in April 2026, 38 months after Cyclone Gabrielle caused major damage to Transpower's transmission assets in the Hawke's Bay in February 2023.[96] This is not intended as a criticism of the Commission. We merely observe that such reopener processes can be complex and lengthy. Watercare cannot wait this length of time before incurring the costs required to restore essential services to consumers. This means that Watercare may endure large shortfalls between the revenues it is allowed to earn and the costs it must incur to deal with disruptions and restore services, in the event of a major event. As Watercare cannot access financial support from its shareholder, it must manage potentially large cash flow mismatches arising from such events on its own. The *Emerging Views* paper notes correctly that:

> *A notional credit rating of A- provides an adequate margin of safety with respect to water services. This margin protects against the possibility that economic downturns or shocks can lead to financial distress.* [97]

However, the benchmark credit rating of A- will only provide the margin of safety referred to above, to manage unexpected shocks, if the Commission ensures that the regulated cash flows in each period are sufficient to support an A- credit rating at the benchmark level of leverage. That is, in addition to within-period revenue adjustment mechanisms, it is imperative that the Commission also formalise a process to ensure that the benchmark efficient firm can remain financeable (at the benchmark credit rating) in each regulatory period.

It is encouraging that the *Emerging View* paper has identified a number of mechanisms that could be used to address financeability problems, should they arise.

However, we are concerned about two aspects of the approach proposed in the *Emerging Views* to address future financeability issues, which we discuss below.

---

96 Commerce Commission, Transpower's Redclyffe major capex project proposal Final decision - reasons paper, 28 April 2026.

97 *Emerging Views* paper, para. D.44.

Presumption that the supplier, rather than the Commission, is responsible for managing financeability problems

Our first concern is that the Commission's default view appears to be that it is the regulated supplier's responsibility to manage financeability problems, for instance by adjusting its dividend policy or seeking equity injections from its owner.

This ignores the fact that financeability problems can emerge even if the supplier has:

- adopted the benchmark level of leverage;
- financed itself to match its cost of debt to the cost of debt allowance; and
- matched its expenditure exactly to the expenditure allowances in the BBM.

In other words, suppliers can encounter financeability problems even if they have matched their costs exactly to the regulator's allowances and financed themselves precisely in line with what the regulator deems to be a prudent and efficient manner. This could occur if the regulator has underestimated the cost of equity allowance, or if forecast inflation is very high (resulting in a large deduction from the BBAR for forecast inflationary gain), or if the supplier is undertaking a large investment program in long-lived assets.

Our view is that the Commission should first identify the source of the financeability problem and then tailor its response accordingly. This is the approach taken by the Independent Pricing and Regulatory Tribunal (**IPART**) in Australia. IPART undertakes formal financeability tests to identify which of the following three scenarios is causing the financeability test problem:[98]

1. *Regulated prices are set too low for even a benchmark efficient firm to maintain the benchmark credit rating (at the benchmark level of leverage) over the regulatory period*.

   IPART has developed a 'benchmark test' to assess this question. The benchmark test assumes that the supplier's revenues and expenditures are exactly in line with those in the BBM, the supplier's cost of debt matches the cost of debt allowance, and that the supplier has adopted a capital structure that matches the benchmark leverage ratio. If a financeability problem is detected under these circumstances, IPART concludes that the source of the concern is that allowed revenues over the regulatory period are too low for even a benchmark efficient firm be financeable. IPART would then conclude that it has made a "regulatory error" and re-assess its pricing decision. This could involve, for instance, reviewing whether its return on equity allowance is too low.

2. *Regulated prices are sufficient for a benchmark efficient firm but insufficient for the actual regulated supplier to maintain the benchmark credit rating (at the benchmark level of leverage)*. This could occur if the owners previously made imprudent or inefficient decisions, such as engaging in inefficient spending which led to a higher leverage ratio and/or interest payments. It could also occur in the future if, for example, the supplier intended to return excessive dividends to its shareholders over the regulatory period.

   In addition to the 'benchmark test', IPART conducts a parallel test of the actual supplier's financeability. If the supplier passes the benchmark test but the actual business is found to have a financeability problem, IPART would conclude that the source of the issue is inefficiency or imprudent financing decisions by the supplier and its owners. In these circumstances, IPART would expect the supplier to manage the financeability problem (e.g., by adjusting its dividend policies, seeking equity injection from its owners or controlling its expenditure).

[98] IPART, Review of our financeability test, Final report, November 2018, p. 60, 63.

3. *Regulated prices are sufficient for the actual regulated business to maintain an investment grade credit rating on average, but the timing of cash flows might create short-term financial problems from time to time*.

   If the supplier fails the benchmark test, IPART investigates if the source of the issue is a temporary cash flow problem—for example because it has undertaken a large investment in very long-lived assets, and the recovery of the cost of that investment via the depreciation allowance is too slow relative to the size of the debt obligations it needs to service. If that is the case, IPART accelerates the depreciation allowance in an NPV-neutral way, to improve the match between cash inflows and outflows.

IPART's approach is preferable to the Commission's apparent presumption that the source of the problem is that the supplier has financed itself imprudently or operated inefficiently, such that it is the responsibility of its owners (rather than the regulatory framework) to manage the problem. The Commission's approach would exclude the possibility that the source of the problem is an error in its decision or a temporary cash flow mismatch, which could arise even if the supplier has operated and financed itself prudently and efficiently.

We therefore propose that the Commission adopt IPART's structured approach to identifying the source of any financeability problem and tailoring its response accordingly, rather than simply defaulting to the view that Watercare is responsible for addressing all financeability problems that could arise in future.

Need for clear evidence of material and persistent financeability pressure before regulatory action is taken

Our second concern is that the *Emerging Views* paper indicates that the Commission would need to see clear evidence of material and persistent financeability pressure before it deploys any of the 'tools' it has available to address a financeability problem faced by Watercare. The *Emerging Views* paper does not explain what the Commission considers constitutes a "material" problem or how "persistent" it would need to be before it acts.

This creates significant regulatory uncertainty. If there is no transparent decision rule that specifies precisely when the Commission will act, and if the circumstances in which action is taken is simply a matter of regulatory discretion, how could Watercare or any other stakeholder predict when the Commission will or will not intervene? We favour a process where the Commission sets out in advance a binding and mechanistic rule that would describe:

- the precise circumstances in which the Commission would act; and
- what that action would entail.

This can be done in practice. We note that in March 2024 the Australian Energy Market Commission (**AEMC**) introduced a requirement for the AER to develop a binding financeability test that had the following features:[99]

- the test must specify a mechanistic rule to determine whether it had been passed or failed, without any role for discretion or judgment by the regulator.
- if the test was failed, the AEMC required the AER to adjust the supplier's regulated cash flows to address the problem—again without any role for discretion by the regulator as to whether such an adjustment was warranted or required; and

[99] AEMC, National Electricity Amendment (Accommodating financeability in the regulatory framework) Rule 2024, Rule determination, 21 March 2024.

- the test must specify in advance precisely what the remedy for a failure of the test would be, without any role for the regulator to decide after the event the quantum of the adjustment (i.e., the size of the adjustment would need to be determined by a mechanistic rule or formula rather than involving regulatory judgment).

The AEMC was persuaded to circumscribe the AER's discretion in this way because it recognised the strong need for certainty and predictability for all stakeholders. The AEMC considered that such an approach was preferable to a "principles-based approach", which would afford the AER greater flexibility and regulatory discretion, because investor confidence that the regulatory framework would solve genuine financeability problems if they emerge is essential to attracting the investment needed to support Australia's energy transition. The AEMC judged that a principle-based approach that relied on regulatory judgement would not provide the necessary certainty and predictability.[100] The AER published details of a financeability test that met the AEMC's requirements in November 2024.[101]

In our view, there is a similarly compelling case for maximum regulatory certainty and predictability, given Watercare's unique financial constraints. As noted above, the Commission's normal expectation is that suppliers should manage financeability problems themselves by adjusting their dividend policy or seeking equity injections from their owners. Watercare can do neither of these things:

- since Watercare is prohibited by law from paying dividends, it has no option to scale back dividend payments to boost its cash flows; and
- since Watercare's shareholder is prohibited by law from providing Watercare any financial support or capital, Watercare cannot seek equity injections to shore up its financeability.

Because Watercare does not have at its disposal these normal 'levers', it does not have the flexibility or capacity to manage financeability problems in the way other suppliers regulated by the Commission might. Watercare, rating agencies and lenders need greater certainty that the regulatory framework will address properly even relatively small and transient deteriorations in financeability that are not caused by imprudent financing and operating decisions by the business because Watercare does not have the financial flexibility and recourse to new equity that other firms typically do.

In summary, we propose that:

- the Commission should publish a transparent financeability test that specifies a mechanistic rule for determining whether the test has been passed or failed;
- the test should assess the financeability of the benchmark efficient firm rather than Watercare's actual financeability, since the failure of such a 'benchmark' test would exclude imprudent financing or inefficient operating decisions by the actual business as a source of the financeability problem;
- the test should specify clear thresholds (rather than tolerance bands) for a failure or a pass so that the outcomes of the test are clear and predictable to Watercare and other stakeholders; and
- the test should specify what binding action the Commission will take in the event the test is failed.

[100] AEMC, National Electricity Amendment (Accommodating financeability in the regulatory framework) Rule 2024, Rule determination, 21 March 2024, p. 7.

[101] AER, Financeability guideline, Final decision, November 2024.

Frontier Economics

Brisbane | Melbourne | Singapore | Sydney

Frontier Economics Pty Ltd
395 Collins Street Melbourne Victoria 3000

Tel: +61 3 9620 4488
www.frontier-economics.com.au

ACN: 087 553 124 ABN: 13 087 553 124