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Economic Regulation of Water Services - Information Disclosure

Technical Working Paper on the Accounting Basis for Regulatory Reporting



Purpose

1. This technical working paper outlines some key areas of accounting that we could require for information disclosure that differ from current practices in local councils and in other regulated sectors. This paper should help staff in water service providers (councils and council-controlled organisations) who work on accounting and reporting, and others who provide services to them, as it provides a view of what may be required in the future.
2. There is a significant connection between the approach to economic regulation and the basis on which accounts are prepared for regulatory tools like information disclosure. This is because accounting standards often underpin the financial aspects of economic regulation. For example, different accounting approaches can significantly affect the value of an organisation's assets, which in economic regulation is often used as a significant input into the calculation of returns.
3. In setting economic regulation, including information disclosure requirements, we have broad discretion in specifying accounting approaches, so long as the regulation is in line with the statutory purpose of the regulation.¹ The scope of what is accounted for will generally be set by legislation and different to the scope of what local councils' accounts currently cover.
4. This paper should be read in conjunction with the *Economic Regulation of Water Services - Information Disclosure - Discussion Paper - February 2025*, which can be found on our [website](#).

Scope and purpose of financial reporting

5. We expect that water service providers will currently be preparing and reporting general purpose accounts under various statutes as well as tax and management accounts. However, future regulatory accounts may differ in purpose and scope from existing accounts because of the boundaries of the service to be covered by economic regulation. The areas covered by economic regulation will often (but not necessarily) be a subset of the areas covered by the other accounts. These potential differences are shown in **Table 1.1** below.

¹ Regulation is currently legislated for under the [Local Government \(Water Services Preliminary Arrangements\) Act 2024](#), and further regulation is proposed to be legislated for through the [Local Government \(Water Services\) Bill](#).

Table 1.1 Purpose and scope of different accounts

Type of accounts	Purpose	Scope
Management	To meet internal requirements to support governance and operational decision-making	To be determined by the organisation
Statutory accounts: Companies Act and Income Tax Act	Legal requirement to report overall financial performance and position and assessable income for tax purposes	Full scope of organisation or group, defined by ownership
Statutory accounts: Local Government reporting	Provide transparency of the council's financial position and performance	Full scope of the council (which may be a subset of the statutory accounts), following generally accepted accounting practice (GAAP)
Statutory accounts: Local Government (Water Services) Bill (proposed)	Provide transparency of water service provider's performance	Water services, prepared on a GAAP basis
Regulatory accounts	<p>To enable stakeholders to understand various dimensions of performance and whether the water service providers are meeting proposed legislated financial principles (like ring-fencing)</p> <p>As input into regulatory tools beyond information disclosure, such as price-quality paths</p>	<p>Regulated water services as determined by legislation, excludes non-water services, may be split between drinking water, wastewater, and stormwater – a subset of the local government reporting accounts</p> <p>Can include consolidated accounts, eg, to assess compliance</p>

6. Statutory accounts based on generally accepted accounting practice (GAAP) include standard reports like Statements of Financial Performance and Position. We will need to consider the extent to which these existing types of accounting reports help meet the intended purpose of information disclosure to decide whether we should require them.
7. We may require additional or different information for regulatory accounts that better allow stakeholders to understand the broader performance of the water service provider. For example, this includes understanding changes in the providers' efficiency over time, which may be difficult to assess from the information in statutory accounts. Management accounts might include similar information but may not be consistent between providers and might cover a different scope of services.

8. Our preference is to rely on GAAP for the rules that apply to information disclosure where it is appropriate for our regulatory purpose, and doing so may help minimise compliance costs.² However, we might determine the use of specific approaches when there is a choice under GAAP, or where we consider that deviating from GAAP is required to support regulatory objectives. It is likely that there will be some differences between the regulatory accounts we require and the existing accounts that the water service providers compile, at least in the longer term.

Accounting basis – capital maintenance

9. One important choice to determine for reporting under the regulatory accounts relates to the underlying capital maintenance concept. Under GAAP, there are two broad approaches to capital maintenance, which are outlined in **Table 1.2**.³

Table 1.2 Relevant differences between accounting approaches

Financial capital maintenance (FCM)

- Focus on maintaining the value of starting capital before recognising a profit
- Recognises capital gains and losses associated with holding the assets as a contribution to income
- In a regulatory context, we have applied FCM alongside historical cost asset valuation for existing and new assets used to supply the regulated service⁴
- If assets are revalued – eg, inflation-indexed – revaluations are recorded as income

Operating capability maintenance (OCM)

- Focus on maintaining the physical productive capacity (or operating capability) of the entity before recognising a profit
- Capital gains (and losses) do not contribute to the operating capability and so do not constitute a profit
- Assets are valued using current cost accounting methods (such as depreciated replacement cost)

10. Our understanding is that water service providers' current approach is to use current cost accounting, consistent with OCM, to report their accounts under GAAP.⁵ However, FCM provides the basis for the preparation of the regulatory accounts under Part 4 of the Commerce Act and Part 6 of the Telecommunications Act.

² The term generally accepted accounting practice is defined in the Financial Reporting Act 2013.

³ See External Reporting Board "[New Zealand Equivalent to the IASB Conceptual Framework for Financial Reporting 2010](#)" (February 2011).

⁴ This is referred to as regulatory asset base (RAB), which is typically established with a deemed historic cost, after which actual expenditure is used to update the RAB along with depreciation and (often) inflation indexation. In other sectors, the initial deemed historic cost has often been based on some form of current cost accounting.

⁵ Our understanding is that councils revalue their assets under a current cost approach and these revaluations are included in comprehensive revenue and expenses and accumulated in an asset revaluation reserve. These asset revaluations are not recognised as profit.

11. FCM is a key accounting approach and economic principle we use to regulate monopoly suppliers in the electricity and telecommunications sectors to create a consistent incentive to invest. FCM provides investors in regulated suppliers with an expectation of a return on capital, and a return of capital based on a regulatory depreciation allowance.⁶ FCM is applied in a way that preserves the value of the invested capital while also compensating for some risks that come from investing capital. We consider that this can support both the investment, and the borrowing required for investment, with an expectation of the investment being recovered over time.
12. The difference between an FCM-based regime and an OCM-based regime can best be illustrated by the differences in the way assets are valued and the purpose of providing a depreciation allowance:
 - 12.1 Under a regulatory regime based on FCM, assets are valued at historical cost. The purpose of the depreciation approach is to provide for the recovery of capital costs already incurred. Any expenditure on replacing assets is treated as new investment which will, in turn, be depreciated on a historical cost basis and suppliers will generally expect to earn a reasonable return on that investment. Revaluations of the assets are treated as income.
 - 12.2 Under a regulatory regime based on OCM, assets are valued with reference to current market values or replacement cost. The purpose of the depreciation is to provide the supplier with the means of maintaining the operating capability of the business at a defined level. This means that regulatory depreciation is viewed as providing the funds for the renewal expenditure. In most OCM applications, depreciation allowances are likely to reflect the cost of replacing the existing asset with an optimised asset (ie, a modern equivalent replacement) rather than the historical cost of the actual asset. Revaluations of the assets are not treated as income.
13. We consider that there are advantages and disadvantages in using FCM or OCM as the basis for reporting the regulatory accounts for water and to set regulatory charges under an enduring regulatory regime. **Table 1.3** highlights the key features of each approach.

⁶ The FCM principle can be implemented using the net present value equals zero (NPV=0) principle. In the context of an investment, the NPV=0 principle ensures that the present value of the cash flow payments to capital (i.e., the free cash flow) equals the initial investment when the weighted average cost of capital is used as the discount rate. This effectively implies that the cash flow payments to capital provide investors with a normal return on capital, and a return of the initial capital invested.

Table 1.3 Comparison of financial capital maintenance and operating capability maintenance

Financial capital maintenance (FCM)	Operating capability maintenance (OCM)
Advantages	
<p>Consistent with incentivising investment, an important requirement for the water sector.</p> <p>A key problem in parts of the water sector has been underinvestment and low returns, not an excess return problem. We consider that the FCM principle can be useful because it provides more certainty for providers of capital, with the expectation of investment by the water service providers being recovered over time.</p> <p>Valuation of new assets when they enter the supplier's total asset value is relatively simple by recording actual costs.</p> <p>Calculation of profitability under FCM also provides appropriate investment signals under increasing or decreasing asset values because revaluations are treated as income.</p>	<p>Strong focus on maintaining the capability of the network at a pre-defined level of capability to produce.</p> <p>Useful for managerial decision-making.</p> <p>Consistent with current cost accounting practices, which councils are already using.</p>
Disadvantages	
<p>We understand that water service providers' current accounting practices are based on an OCM approach (including valuing assets by applying optimised depreciated replacement cost) rather than an FCM approach. If FCM is more appropriate, we would need to consider the practicalities of transitioning to a system of reporting regulatory accounts based on FCM.</p> <p>Any economic regulation approach based on an FCM principle will need to ensure that sufficient revenues are generated to pay for the infrastructure investment needs over time, while providing a path to financial sustainability. Under an FCM approach, the ability to achieve this objective is likely to depend (among other relevant factors) on the initial value assigned to water assets.</p> <p>Initially setting a total value of assets for an organisation can be challenging.</p>	<p>An OCM-based approach can expose regulated suppliers to the risk associated with unpredictable changes in capital costs relative to prices over time, meaning that they do not recover past investment in real terms, even where such investment is prudent and efficient.</p> <p>An OCM approach can equally result in windfall profits—in other words, profits that are not earned because of superior performance, but as a result of circumstances outside the regulated supplier's control.</p> <p>Deriving replacement cost values can often be a difficult exercise subject to significant judgement.</p> <p>Investment signals when asset values are increasing or decreasing may be inappropriate because revaluations are not treated as income (eg, lower depreciation on declining asset values will result in increased profitability, encouraging new investment, even though this investment may not be sustainable).</p>

14. One of the most significant decisions involved in establishing a new regulatory regime is whether, and if so how, to determine an initial total value of assets. Even if we choose to base the regime on the FCM principle, which values new assets at historical cost, we may choose an alternative approach to setting the initial value of existing assets. Once the initial total value of assets is established, it typically becomes a 'deemed' historical value at that point representing the financial capital already used by the supplier to provide regulated services, irrespective of the methodology used to determine it.
15. Overall, we will need to consider which capital maintenance approach is appropriate to apply to water service providers. One option we will consider is for water service providers to continue with their existing approaches to financial reporting to begin with. We would then consider whether to transition to FCM at some point in the future if it is in the long-term benefit of consumers of regulated water services.